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In the Supreme Court of the United States

OCTOBER TERM, 1962

No. 305

A. J. WHIPPLE & MILDRED WHIPPLE, *Petitioners*

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

MEMORANDUM FOR THE COMMISSIONER

Under the Internal Revenue Code of 1939 bad-debt losses are fully deductible only if they are incurred in a trade or business of the taxpayer.[1] This case presents the question whether the activity of the taxpayer, A. J. Whipple, in organizing, financing, and managing the Mission Orange Bottling Co., a corporation of

---

[1] Otherwise such losses are deductible within the limits prescribed for short term capital losses. Internal Revenue Code of 1939, Secs. 23(k)(1), (4), 117(d)(2). Similar rules are established by the Internal Revenue Code of 1954, Secs. 166(a), (d), 1211.

which he owned 80% of the stock constituted—either by itself or in conjunction with the taxpayer's similar activities in connection with a number of other corporations engaged in distinct enterprises—a "business" so that losses from the non-repayment of loans to the bottling corporation were fully deductible as "business" bad debts.

Having found that the taxpayer hoped to profit from the business activities of the corporations in which he owned stock and not from his own activities as promoter of these corporations or dealer in their stock, both the Tax Court and the Court of Appeals for the Fifth Circuit sustained the Commissioner's disallowance of the claimed deduction. Their decisions thus hold that, for the purposes of a taxpayer's claim of a deduction for a business bad debt, the business of a corporation is not the individual business of any of its shareholders, not even of a shareholder who actively engages as an individual in running the affairs of the corporate entity. They also hold that a taxpayer whose hope of profit springs from operations being carried on by a corporation—or several of them—of which he is a shareholder, is not in the "business" of organizing, financing, and managing corporations.

We believe that the decision below is correct. It is consistent with decisions of the Courts of Appeals for the Second[2] and Ninth[3] Circuits. It appears, however, to be in direct conflict with a recent decision of the Court of Claims[4] and to conflict, at least in principle, with the decisions of several courts of appeals.[5] Since

[2] *Wheeler* v. *Commissioner*, 241 F. 2d 883.

[3] *Holtz* v. *Commissioner*, 256 F. 2d 865.

[4] *Maytag* v. *United States*, 289 F. 2d 647.

the question on which these courts are in conflict is one of continuing importance, and since this case is an appropriate one for its resolution, we do not oppose the issuance of a writ of certiorari.

Respectfully submitted.

ARCHIBALD COX,
Solicitor General.

SEPTEMBER, 1962.

[5] *E.g.*, *Mays* v. *Commissioner*, 272 F. 2d 788 (C.A. 6); see also, *Washburn* v. *Commissioner*, 51 F. 2d 949 (C.A. 8); *Foss* v. *Commissioner*, 75 F. 2d 326 (C.A. 1); *Commissioner* v. *Stokes' Estate*, 200 F. 2d 637 (C.A. 3).

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BRIEF FOR PETITIONER

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SUBJECT INDEX

	PAGE
OPINIONS BELOW	1
JURISDICTION	1
STATUTES INVOLVED	2
QUESTION PRESENTED	3
STATEMENT OF THE CASE	3
POINTS FOR REVIEW	14-15
SUMMARY OF ARGUMENT	15
Summary of First Point	15
Summary of Second Point	17
Summary of Third Point	20
Summary of Fourth Point	20
FIRST POINT (RESTATED)	23
A. Interpretation Clear 1942-1954	24
B. Enactment of Internal Revenue Code of 1954 Confirmed Prior Decisions	36
SECOND POINT (RESTATED)	41
THIRD POINT (RESTATED)	54
FOURTH POINT (RESTATED)	60
CONCLUSION	77
PROOF OF SERVICE	78

LIST OF AUTHORITIES

CASES	PAGE
Alexander v. Commissioner, 34 TC 758	18, 40, 42, 43
Averill v. Commissioner, 20 BTA 1196	30, 43
Bingham's Trust v. Commissioner, 325 U.S. 365, 89 L.Ed. 1670	64
Campbell v. Commissioner, 11 TC 510	16, 17, 18, 27, 28, 30, 36, 37, 39, 40, 41, 43, 44, 50, 66, 69, 75
Cluett v. Commissioner, 8 TC 1178	26, 27, 28
Commissioner v. Bedford, 325 U.S. 283, 89 L.Ed. 1611	64
Commissioner v. LoBue, 351 U.S. 243, 100 L.Ed. 1142	64
Commissioner v. Stokes' Estate, (3 Cir.) 200 F.2d 637, 53-1 USTC para. 9164	14, 16, 18, 34, 35, 36, 40, 42, 43, 59, 66
Commissioner v. Smith, (2 Cir.) 203 F.2d 310, 53-1 USTC para. 9317	31, 65
Dobson v. Commissioner, 320 U.S. 489, 88 L.Ed 389	64
Flint v. Stone Tracy Co., 220 U.S. 107, 55 L.Ed 389	31
Foss v. Commissioner, (1 Cir.) 75 F.2d 326, 35-1 USTC para. 9091	14, 16, 17, 18, 29, 30, 35, 36, 40, 42, 43, 66, 67, 68
Giblin v. Commissioner, (5 Cir.) 227 F.2d 693, 56-1 USTC para. 9103	17, 37, 40, 42, 43, 45, 46, 47, 48, 49, 59
Higgins v. Commissioner, 312 U.S. 212, 85 L.Ed. 783	59, 72
Holtz v. Commissioner, (9 Cir.) 256 F.2d 865, 58-2 USTC para. 9620	17, 42, 43, 44, 45, 47, 49
Lutz v. Commissioner, (5 Cir.) 282 F.2d 614, 60-2 USTC para. 9687	74
Maloney v. Spencer, (9 Cir.) 172 F.2d 638, 49-1 USTC para. 9176	14, 16, 17, 18, 19, 32, 36, 37, 39, 40, 41, 42 50, 55, 56, 59, 60, 66, 72
Macy v. Commissioner, 8 TCM 45	16, 28, 29, 30, 35, 36, 40, 43, 69, 75
Mays v. Commissioner, (6 Cir.) 272 F.2d 788, 60-1 USTC para. 9122	13, 17, 18, 38, 41, 43, 50, 59, 65, 68, 69
Maytag v. U. S., (U. S. Court of Claims) 289 F.2d 647, 61-1 USTC para. 9424	14, 17, 18, 39, 42, 69
Pokress v. Commissioner, (5 Cir.) 234 F.2d 146, 56-2 USTC para. 9610	45, 49
Putnam v. Commissioner, 352 U.S. 82, 1 L.Ed.2d 144	37
Rollins v. Commissioner, (4 Cir.) 276 F.2d 368, 60-1 USTC para. 9357	46
Rollins v. Commissioner, 32 TC 604	46
Sage v. Commissioner 15 TC 299	16, 18, 33, 34, 35, 36, 37, 40, 42 ,50, 63, 66
Scott v. Commissioner, 14 TCM 1029, TCMemo 1955-258	17, 18, 37, 40, 42, 43, 50, 59, 71

CASES	PAGE
Trent v. Commissioner, (2 Cir.) 291 F.2d 669, 61-2 USTC para. 9506	17, 18, 42, 59
Vreeland v. Commissioner, 31 TC 78	46
Washburn v. Commissioner, (8 Cir.) 51 F.2d 949, 2 USTC para. 791	14, 18, 30, 42, 49, 65, 66, 75

STATUTES AND TEXTS	
1942-2 Cumulative Bulletin 409	24
1942-2 Cumulative Bulletin 572	24, 25
1942-2 Cumulative Bulletin 431	25
1947-2 Cumulative Bulletin 2	26, 27
1949-1 Cumulative Bulletin 1	16, 28
1951-1 Cumulative Bulletin 3	34
26 USCA, Sec. 23(k)(1) IRC 1939	2, 3, 17, 29, 35, 36, 66
26 USCA, Sec. 23(k)(4) IRC 1939	2, 3, 13, 15, 16, 17, 19, 24, 26, 27, 28, 30, 31, 34, 36, 37, 38, 41, 61, 66, 77
26 USCA, Sec. 23(e) IRC 1939	15, 25, 30, 31
26 USCA, Sec. 23(a) IRC 1939	29
26 USCA, Sec. 166(a) IRC 1954	17, 36
26 USCA, Sec. 166(d) IRC 1954	17, 36
26 USCA, Sec. 114(a) IRC 1939	2
26 USCA, Sec. 7482(a) IRC 1954	2
28 USCA, Sec. 1254(1)	2
5 Am. Jur. 2nd p. 268	64
5 Am. Jur. 2nd p. 272	64
63 CCH Tax Service para. 1627.461	38
Art. 5070, Vernon's Annotated Statutes of the State of Texas	71
Treasury Regulation 39.23(k)-6(b)	3

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ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT BRIEF FOR PETITIONER

OPINIONS BELOW

The opinion of the Tax Court (R. 24) is reported as a memorandum decision in 19 TCM 187, TC Memo 1960-36. The opinion of the Court of Appeals for the Fifth Circuit (R. 133) is reported at 301 F. 2d 108, 62-1 USTC para. 9385.

JURISDICTION

The judgment of the Court of Appeals was entered on April 4, 1962 (R. 144). Rehearing was denied on May 11,

1962 (R. 148). Petition for a writ of certiorari was filed August 7, 1962 and was granted October 22, 1962. The jurisdiction of this Court rests on 26 USCA, Sec. 1141(a) Internal Revenue Code of 1939 (26 USCA, Sec. 7482(a) Internal Revenue Code of 1954) and 28 USCA, Sec. 1254(1).

STATUTES INVOLVED

The statutes in question are Section 23(k)(1) and Section 23 (k)(4) of the Internal Revenue Code of 1939, 26 USCA, IRC 1939, Section 23(k) p. 46.

Section 23 (k)(1) of Internal Revenue Code, 1939 (k) Bad Debts

> (1) General Rule—Debts which become worthless within the taxable year; or (in the discretion of the Commissioner) a reasonable addition to a reserve for bad debts; and when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction. This Paragraph shall not apply in the case of a taxpayer, other than a bank, as defined in section 104, with respect to a debt evidenced by a security as defined in paragraph (3) of this subsection. This paragraph shall not apply in the case of a taxpayer, other than a corporation, with respect to a non-business debt, as defined in paragraph (4) of this subsection . . .

Section 23(k)(4) of the Internal Revenue Code of 1939

> (4) Non-Business Debts—In the case of a taxpayer, other than a corporation, if a non-business debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset

held for not more than 6 months. The term "non-business debt" means a debt other than a debt evidenced by a security as defined in paragraph (3) and other than a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

QUESTION PRESENTED

The sole issue in this case is whether the $56,975.10 debt of Mission Orange Bottling Co. of Lubbock, Inc., to Petitioner, A. J. Whipple, was a business bad debt or a non-business bad debt within the meaning of Section 23(k)(1) or Section 23(k)(4), respectively, Internal Revenue Code of 1939. It was stipulated (1) that it was a debt; and (2) that it became worthless in 1953. (R. 56).

This turns on whether or not the loss resulting from the debt's becoming worthless bore a proximate relationship to the conduct of a business in which Petitioner, A. J. Whipple, was engaged at the time it became worthless. T. R. 39:23(k)-6(b).

STATEMENT OF THE CASE

A. J. Whipple and Mildred Whipple are husband and wife and reside in Houston, Texas. They filed their joint income tax returns for 1952 and 1953 with the District Director of Internal Revenue at Austin, Texas. Albert J. Whipple, as head of the marital community within the meaning of the community property laws of the State of Texas, will hereinafter be referred to as "Petitioner". (R. 41)

Petitioner started into business for himself in 1941 by going into a building partnership with W. E. Brown, which continued for about a year. (R. 84-85).

Petitioner then entered into a construction partnership with Miles Strickland and W. C. Perkins under the name of SWP Construction Company to build houses in Greens Bayou, Harris County, Texas (R. 85). About the same time Miles Strickland offered to let Petitioner build a shopping center and houses for 24 per cent of the stock in a corporation known as Industrial Homes (R. 86) which was to own them.

~~In 1943~~ Petitioner, with others, promoted the formation of a corporation called Harbor Homes, in which Petitioner acquired a 40 per cent interest. It finished 63 housing units in Meadwood Estates, which had been taken over by a bonding company in a bankruptcy. (R. 86).

Petitioner bought some land on Airline Road and started to build a materials yard to go into business with one John Anderson. Strickland later wanted to get in and was taken as a one-third owner in a corporation that they formed called "Airline Lumber and Supply, Inc." (R. 90-91).

Petitioner then formed 29th and Airline, which built the yard and rented it to Airline Lumber & Supply, Inc. (R. 93) He also helped organize the partnerships, S. & W. Construction Company, Evergreen Rice Company, Ltd., Gulf Coast Plumbing and Supply, and State Tile Distributors. (R. 93).

State Tile Distributors was a wholesale tile company, which Petitioner, with George Listi, promoted by taking a trip, first to Cincinnati, and then to Anderson, Indiana. This was right after the War, when tile was still on government allocation; and, at first, they had difficulty. Finally, by talking with the Sales Manager of National Tile Company (R. 88-89), over a few drinks and lunch Petitioner offered to

buy four carloads of tile for $50,000 and they made a trade; all before they even had a name for the company. (R. 89). Miles and Bentley Strickland were then taken in as the other partners. (R. 88). Later Shakertown Distributors was formed with a John W. Anderson to distribute shingles. (R. 90).

During the years 1949 and 1950, Petitioner was an original incorporator of 7 corporations, as follows: Federal Road Building Corporation; Richmond Plaza, Inc.; Strickland-Whipple Construction Company, Inc., a successor to the partnership S. & W. Construction Company; Airline Lumber and Supply Company, Inc., a successor to the partnership, Airline Lumber and Supply Company, Ltd.; Dorwayne Construction Corporation; 29th and Airline, Inc., a real estate rental corporation which owned and rented the property occupied by Airline Lumber and Supply Company, Inc., and Shakertown Distributors; and Federal Road Lumber Company, Inc. (R. 25).

Petitioner, through his efforts, also acquired an interest in three Federal Housing Administration 608 apartment rental projects, Commonwealth and California, Commonwealth and Missouri, and Riverside Apartments. (R. 97-98).

In 1951 Petitioner's interests in all the various corporations and partnerships in which he had an interest were bought out by his partner and fellow stockholder, Miles Strickland, at book value, (R. 93-94) and Petitioner formed new ones with the money. (R. 95-96).

Petitioner bought property on Bissonnet and formed Whipple Lumber Company. (R. 95). He bought a restaurant on Fannin Street in April and a bottling plant in Lubbock. (R. 95). Later Petitioner bought some land in Bellaire and in Pasadena. (R. 95).

Petitioner helped promote an oil venture in West Texas with a group of people, and went into oil lease deals in Washington and Lee Counties. (R. 65). He helped organize a club to help the business in his restaurant. (R. 104-105). He bought land for Foley's warehouse when they only had five days in which to do it before construction was to be commenced, for which he was paid a fee reported as ordinary income. (R. 109-110). He was frequently brought other deals to help promote and for which to raise money, (R. 69) such as a cinder block business in 1953, (R. 66). He went into a lumber yard promotion deal with Alex W. Head after that. (R. 66).

Stipulation 23 (R. 46) gives some idea of the variety of Petitioner's activities.[1]

---

[1] On March 18, 1953, petitioners filed a joint individual income tax return, Form 1040, for the taxable year 1952. Photostat thereof is hereto attached, marked Exhibit 13-M, and made a part hereof, showing income from the following sources:
(fol. 61

Form No.	Company	Exhibit No.
W-2	Whipple Lumber Company	13-M1
W-2	Whipple Construction Company	13-M2
W-2	Whipple Equipment Co., Inc.	13-M3
W-2	Angleton Homes Corp.	13-M4
W-2	Dozier-Whipple Const. Corp.	13-M5
1099	Federated Department Stores, Inc.	13-M6
1099	Durham-Clark Building Supply Co.	13-M7
1099	Whipple Lumber Company	13-M8

Interest received from 14 corporation, partnerships, and corporations:
Restaurant
Partnership
Lee County Oil Lease
Rent House Houston
Rental Building in Lubbock

In 1951 Petitioner formed a partnership, A. J. Whipple Construction Company, with V. L. Yarborough, Leonard Olive and G. A. Durham, and later A. J. Whipple Construction Company No. 2 with D. M. Dozier, (R. 100). He also formed the following corporations: Dozier-Whipple Construction Company, Whipple Construction Company, Inc., Angleton Homes, Inc., Chevy Chase Development Corporation, and Angleton Building and Holding Company. (R. 26).

In 1951 Petitioner also undertook the financing of these corporations, as shown by the interest schedule of ordinary income on his 1951 income tax return (R. 29), which shows interest received from five corporations as well as three partnerships. (R. 29)

Petitioner consistently financed the various partnerships and corporations in which he did have an interest through loans either individually or through a partnership (R. 92, R. 98, R. 100, R. 121).

Petitioner continued in this business of financing corporations and lending money, as is shown by the schedule attached to his 1952 income tax return showing ordinary interest income received from 14 corporations, partnerships and individuals (R. 156); and the advances in 1953 of $25,000 to $30,000 to Angleton Building and Holding Co. (R. 121); and the $52,500.00 advanced to Mission Orange Bottling Co. of Lubbock, Inc. (R. 63, Exhibit 21; R. 183ff).

His income tax returns for the years 1951-53 reflect interest income of $1,680.15, $2,285.35, and $1,747.59 respectively (R. 29).

Petitioner had also continued in the rental business forming Whipple Equipment Corporation in 1951 to rent auto-

mobiles, trucks, construction and other equipment (R. 101). In addition he bought personally the property and buildings at 2436 Bissonnet which he leased to Whipple Lumber Company, Inc. (R. 102-103, R. 106). This served as the home office of all the other corporations and partnerships which Petitioner controlled (R. 103). He also owned a rent house in Houston. (R. 46, Exhibit 13-M; R. 176) Petitioner individually bought some land in Lubbock and built a plant on it which he leased to Mission Orange Bottling Company of Lubbock, Inc. (R. 28; R. 116). Petitioner reported ordinary income of $15,570.58 as net rentals for the taxable year ending December 31, 1952, (R. 111; R. 47; Exhibit 13-M, R. 154) and $12,225.19 for the taxable year ending December 31, 1953 (R. 47, R. 111; Exhibit 20-T.; R. 176).

Petitioners formation and operation of these enterprises, also generated ordinary income in the form of salaries of $29,400.00 paid him in 1952 and $33,450.00 paid in 1953 (R. 26).

Petitioner organized a separate corporation by putting in 76 per cent of the original capital to act under a separate franchise as a distributor of franchised soft drinks in the Amarillo area which were bottled in the Mission Orange plant in Lubbock (R. 112-114).

Petitioner also organized a soft drink vending machine business separate and apart from the Mason Root Beer or Mission Orange Bottling operations with Ideal, Indiana. (R. 114-115).

On April 17, 1951, D. C. Casey, the owner and operator of Mission Orange Bottling Co., entered into an agreement, whereby he granted to Petitioner an option to purchase Mission Orange Bottling Co. (R. 42).

One of the principal conditions of the Casey-Whipple purchase option was that Petitioner obtain an assignment or a new lease of the premises on which Mission Orange Bottling Co. was then conducting its business, which new lease was obtained. (R. 42-43). Another prime condition was that Petitioner obtain a franchise from Mission Dry Corporation, authorizing him to distribute Mission Orange beverages. After Petitioner had been investigated for his financial and business ability to operate and manage a bottling plant, on April 25, 1951, Mission Dry Corporation of California issued a franchise for the Lubbock area to Petitioner personally. (R. 43; R. 57).

On April 27, 1951, D. C. Casey transferred by bill of sale the machinery and equipment of Mission Orange Bottling Co., located at 2518 Avenue H in Lubbock, to petitioner substantially according to the terms of the purchase option. (R. 43).

Upon consummation of the purchase option Petitioner assumed operations of the bottling business as a sole proprietorship and filed an assumed name certificate as Mission Orange Bottling Co. (R. 43).

Petitioner continued to operate Mission Orange as a sole proprietorship from date of its acquisition until July 1, 1951, at which time a $20,000 corporation, Mission Orange Bottling Co. of Lubbock, Inc., which Petitioner had incorporated, acquired most of the assets from him. (R. 27). He did not transfer the franchise to Mission Orange Bottling Co. of Lubbock, Inc. (R. 27) but continued to hold it personally through 1953. (R. 57).

The charter of Mission Orange was amended on December 7, 1952, to increase the authorized capital stock to $40,000.

Thereafter, the issued and outstanding stock was held as follows: (R. 45)

Shareholder	*Shares*	*Per Cent*	*Par Value*
Petitioner	308	77.	$30,800
James A. Finley	10	2.5	1,000
Charles Dillingham	2	.5	200
Cecil Clark	20	5.	2,000
Dora B. Ellzey	10	2.5	1,000
D. M. Dozier	10	2.5	1,000
Jack Knostman	20	5.	2,000
James F. Webster	20	5.	2,000
Total	400	100.	$40,000

Sometime prior to the end of 1953, Petitioner increased his holding to 318 shares, which was 79.5 per cent of those outstanding and represented an investment of $31,800. (R. 62).

In 1952 Petitioner erected a bottling plant on land which he purchased in Lubbock, Texas. (R. 116). The land and building cost a total of $43,601.70. On July 14, 1952, Petitioner leased this plant to Mission Orange for a 10-year term, beginning August 1, 1952, with an option to renew. The prescribed rental was $500.00 per month for the first 3 years and $500.00 per month plus 1 per cent of gross sales thereafter. (R. 44, R. 28).

During the years 1951, 1952 and 1953 Petitioner made 35 or 40 trips to Lubbock, and Mr. Finley, the plant manager in Lubbock, made a number of trips to Houston to discuss how the business was being run. (R. 118). Throughout this time Petitioner made all the managerial decisions as to policies, prescribed the business practices that should be followed, (R. 57, R. 117-119) and kept close control.

There were frequent long distance conversations between Petitioner and Mr. Finley on the bottling operations. (R. 118). In 1952 Petitioner started requiring Finley to file detailed reports to him every 24 hours, so that Petitioner could keep a check on and control of the business and again in 1953 sent Finley detailed letters of instructions (R. 117-118).

Finally in August, 1953, Finley's employment was terminated and Petitioner acted thereafter, and was acting on December 15, as Plant Manager, having only a plant superintendent in Lubbock (R. 119).

From July 1, 1951, until December 31, 1953, Petitioner paid expenses for Mission Orange Bottling Co. of Lubbock, extended credit to, loaned money to, made advances to or Inc., in the total amount of $131,778.26, and was repaid $74,803.16, leaving a net indebtedness of $56,975.10 (R. 75). Some of these advances and repayments were made through partnerships in which Petitioner had an interest, but in each case Petitioner personally was either charged or credited with the item. (R. 75-76). Others were in the form of guarantees which he had to make for the corporations accounts and loans. (R. 121)

Virtually all of the $131,778.26 loaned or advanced by Petitioner to Mission Orange Bottling Co. of Lubbock, Inc., except $25,502.50 representing the indebtedness against the assets of the proprietorship transferred by Petitioner to the corporation, were for the purpose of paying operating expenses, (R. 75) the last of which was in the amount of $48,000 on December 15, 1953. (R. 102-103; Exhibit 21, R. 183ff).

On the same date Petitioner was repaid $75,803.16 by Mission Orange Bottling Co. of Lubbock, Inc.'s transferring all of the bottling equipment of the corporation which Petitioner took in satisfaction of $67,332.91 worth of indebtedness, and an automobile which Petitioner took in satisfaction of $3,081.75 of indebtedness. (R. 77-78) This left the Mission Orange Co. with virtually no tangible assets, and as stipulated (R. 28) the debt became worthless.

Petitioner's activities during 1953 were not restricted to Mission Orange Bottling Co. of Lubbock, Inc. He continued to operate Cousin's Restaurant (R. 111), but the operation resulted in a $3,960 loss during 1953 (R. 178). He was also building and selling houses in several locations (R. 26; R. 111) and renting real estate (R. 112). Besides these activities and his management of Whipple Lumber Company and Whipple Equipment Company, Inc. (R. 101), he was brought other deals to consider, such as the cinder block business. (R. 66). As shown by his tax return for 1953 (R. 174), he received salaries from six corporations, income from one partnership in the amount of $27,177, interest of $1,747 and rentals from three properties (R. 176). He also loaned Angleton Building and Holding Corporation, a corporation which he had organized and managed (R. 96), between $25,000 and $30,000 during that year. (R. 121).

Petitioner introduced evidence in the Tax Court on four different types of business activities carried on by taxpayer, A. J. Whipple, for the purpose of producing ordinary income. (R. 45-47). This evidence also showed that the $56,975.10 bad debt in question had resulted from loans having been made by Petitioner in the ordinary course of carrying on these business activities.

Petitioner urged before the Tax Court and the United States Court of Appeals for the Fifth Circuit (R. 39) that the bad debt loss had resulted from Petitioner, A. J. Whipple's business activities in

1. Organizing, financing and managing corporations, partnerships and joint-ventures; or
2. Financing corporations and lending money; or
3. Acquiring, owning, expanding, equipping and leasing bottling plants and other equipment; or
4. Conducting activities in connection with the bottling and sale of soft drinks; or
5. A combination of the above activities.

Both the Tax Court and the majority of the Court of Appeals for the Fifth Circuit held that Petitioner, A. J. Whipple's activities in connection with points 1, 2 and 4 above did not qualify him for business bad debt treatment but made no finding as to points 3 and 5.

In so holding the Tax Court and the majority of the Court of Appeals for the Fifth Circuit held that in order for a taxpayer to deduct as a business bad debt one of many loans made in the course of organizing, financing and operating numerous corporations, he must also prove that he formed the corporations for the purpose of selling them.

Petitioner filed a Petition for a Writ of Certiorari in this Court on the grounds that the holding of the majority of the Court of Appeals for the Fifth Circuit below was in direct conflict with the following cases on the proper interpretation of Section 23(k)(4) IRC 1939: *Mays v. Commissioner*, (6 Cir.), 272 F. 2d 788, 60-1 USTC para.

9122, *Maloney v. Spencer* (9 Cir.), 272 F. 2d 788; 49-1 USTC para. 9176. *Commissioner v. Stokes' Estate*, (3 Cir.) 200 F. 2d 637, 53-1 USTC para. 9164, *Maytag v. United States* (U. S. Court of Claims), 289 F. 2d 647, 61-1 USTC para. 9424. It would appear that it is, also, in conflict with the case of *Foss v. Commissioner* (1 Cir.), 75 F. 2d 326, 35-1 USTC para. 9091 and *Washburn v. Commissioner* (8 Cir.), 51 F. 2d 949, 2 USTC para. 794.

POINTS FOR REVIEW

First Point

Congressional history shows that the addition of Section 23(k)(4) by the Revenue Act of 1942 was not intended to deny a busines bad debt deduction in the fact situation of this case.

Second Point

The majority of the Court of Appeals for the Fifth Circuit erred in affirming the holding of the Tax Court that the taxpayer in order to deduct as a business bad debt one of many loans made in the course of his extensive activities in organizing, managing and financing numerous corporations, must also prove that he was a person who had formed the corporations for the purpose of selling them.

Third Point

The majority of the Court of Appeals for the Fifth Circuit and the Tax Court erred in failing to find that Petitioner was in the business of acquiring, own-

ing, expanding, equipping, leasing and renting real estate out of the conduct of which business the $56,975.10 bad debt resulted.

Fourth Point

The Court of Appeals for the Fifth Circuit and the Tax Court erred in failing to hold that the extensive activities of the taxpayer in organizing, managing, operating, financing, lending, equipping and renting to corporations, partnerships and joint ventures constituted a business to which the $56,-975.10 bad debt was proximately related.

SUMMARY OF ARGUMENT

Summary of First Point

Prior to 1942 all bad debt losses were fully deductible under Section 23(k). This was abused by individuals making personal loans, and the Committee Reports on the Revenue Act of 1942 state this to be the chief reason for the insertion of Section 23(k)(4) which provides that a non-business bad debt shall be given short term capital loss treatment.

The Treasury Regulations provide that whether the debt is to be treated as a business or non-business bad debt is determined on the basis of its proximate relationship to the taxpayer's business at the time it becomes worthless.

It has been held that the Committee Reports made it clear that the meaning of "business" within Section 23(k) was the same as that used in Section 23(e)(1) as distinguished from "transactions entered into for profit" within Section 23(e)(2).

The basic rule that was adopted[1] and universally followed[2] by the courts from the enactment of Section 23(k)(4) in 1942 up to and through the enactment of the Revenue Code of 1954 was stated in the *Foss* case[3] as follows:

> "the line comes between those who take the position of *passive investors* doing only what is necessary from an investment point of view and those who associate themselves actively in the enterprises in which they are financially interested and devote a substantial part of their time to that work as a matter of business." (Emphasis supplied).

Under this "more than a passive investor" test it was held in the *Campbell* case[4], acquiesced in by the Treasury Department[5] and affirmed by later cases[6] that a taxpayer who organizes a number of corporations and actively participates in their management is considered to be in a business separate and distinct from that of the corporations and entitled to business bad debt treatment on loans to those corporations.

Similarly, one who acquires, manages, finances, equips and rents to corporations is considered to be in a business separate and distinct from that of the corporations and entitled

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[1] **Macy v. Commissioner,** 8 TCM 45

[2] **Macy v. Commissioner,** 8 TCM 45; **Sage v. Commissioner, 15** TC 299; **Maloney v. Spencer,** (9 Cir.) 172 F. 2d 638; 49 UST para. 9176; **Commissioner v. Stokes, (3 Cir.)** 200 F. 2d 637; 53-1 USTC para. 9164.

[3] **Foss v. Commissioner,** (1 Cir.) 75 F. 2d 326, 35-1 USTC para. 9091.

[4] **Campbell v. Commissioner,** 11 TC 510.

[5] 1949 - CB 1.

[6] **Macy, Sage, Stokes.** (supra Note 2).

to business bad debt treatment on loans to those corporations.[7]

The reenactment by Congress without substantially changing Sections 23(k)(1) and 23(k)(4) into Sections 166(a) and 166(d) should certainly be considered as a clear affirmation of the above stated rules.

The first case[8] decided after the enactment of the 1954 Code followed the *Foss* and *Campbell* rules, as have the great weight of authorities[9] since. Due to its reliance upon the misinterpretation by one court[10] of the loose language used in the dictum in another[11] case, the Tax Court below erred, and such error was affirmed by the Court of Appeals in imposing an additional requirement for qualification for business bad debt treatment, namely, that the corporations be organized for sale.

This was not intended by Congress and makes a radical departure from established law.

Summary of Second Point

The sudden addition of the requirement that corporations must be formed for sale was reversible error. The Tax Court

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[7] **Maloney v. Spencer,** (9 Cir.) 172 F. 2d 638; 49 USTC para. 9176.

[8] **Scott v. Commissioner,** 14 TCM 1029.

[9] **Mays v. Commissioner,** (6 Cir.) 272 F. 2d 788; 60-1 USTC para. 9122; **Maytag v. U.S.,** (U.S. Court of Claims) 289 F. 2d 647; 61-1 USTC para. 9424; **Trent v. Commissioner,** (2 Cir.) 291 F. 2d 669; 61-2 USTC para. 9506.

[10] **Holtz v. Commissioner,** (9 Cir.) 256 F. 2d 865; 58-2 USTC para. 9620.

[11] **Giblin v. Commissioner,** (5 Cir.) 227 F. 2d 692; 56-1 USTC para. 9103.

based its denial of the business bad debt deduction to Petitioner upon the fact that the record did not show that his purpose for organizing, financing and managing corporations was to develop them for sale to customers in the course of the business of promoting. This was the application of an incorrect legal standard and is reversible error.

The Tax Court cited as authority for this rule a Ninth Circuit case [12], which, in affirming the holding of the Tax Court as "not being clearly erroneous", had seized on certain loose language used in the dictum of a Fifth Circuit case[13] and misquoted the language of *Campbell v. Commissioner* (supra) to distinguish them.

This requirement, that corporations be formed for sale, is completely in conflict with a long line of cases,[14] including those of five of the seven Circuits passing on the question and the Court of Claims. The cases in using the "*more than a passive investor*" rule of the *Foss*[15] case allowed business bad debt deductions to taxpayers who organized a number of corporations and actively took part in their management. In none of these cases were the corporations organized for the purpose of sale.

[12] See Note 10.

[13] See Note 11.

[14] **Campbell v. Commissioner,** 11 T.C. 510; **Mays v. Commissioner** (6 Cir.), 272 F. 2d 788, 60-1 USTC para. 9122; **Maloney v. Spencer,** (9 Cir.) 172 F. 2d 638, 49-1 USTC para. 9176; **Commissioner v. Stokes' Estate,** (3 Cir.) 200 F. 2d 637, 53-1 USTC para. 9164; **Sage v. Commissioner,** 15 T.C. 299; **Scott v. Commissioner,** 14 T.C.M. 1029; **Alexander v. Commissioner,** 34 T.C. 758; **Trent v. Commissioner,** (2 Cir.) 291 F. 2d 669, 61-2 USTC para. 9506; **Maytag v. U. S.** (U. S. Court of Claims), 289 F. 2d 647, 61-1 USTC para 9424; **Foss v. Commissioner** (1 Cir.), 75 F. 2d 692, 35-1 USTC para 9091; and see also **Washburn v. Commissioner** (8 Cir.), 51 F. 2d 949, 2 USTC para. 794.

[15] **Foss v. Commissioner,** 75 F. 2d 326; 35 USTC para. 9091.

Thus this sudden addition of the requirement of the Tax Court, which was affirmed by the Court of Appeals below, is a radical departure from the established law as laid down by the cases and which, coming after the reenactment of Section 23 (k) (4), in substantially the same form, into the comprehensive Revenue Act of 1954, is clearly contrary to the intent of Congress.

The Tax Court's rationale for the adoption of such a rule, as indicated in its comments at the end of the trial, is that the word "business" connotes the generation of ordinary income, and that a promoter who organizes and sells corporations would be creating ordinary income.

There is no disagreement with the proposition that a promoter who sold corporations would create ordinary income and would be entitled to business bad debt treatment. However, it does not follow that this is the only way one who is engaged in organizing corporations can generate ordinary income. Another way, which the Tax Court actually mentioned in its comments but failed to take into consideration in its decision, is the creation of salary. As several of the cases have indicated, salaries are quite frequently paid for the over-all managerial functions made necessary by the complexities of organizing, managing and financing numerous corporations. Another is through interest paid for the financing of such corporations. A third is through rental income.

Petitioner, as is shown in detail under the Third and Fourth Points, carried on such extensive activities in connection with the organization active management, financing, renting to, and equipping of the numerous corporations formed as to generate substantial amounts of all three forms of ordinary income, as a result of which activities he suffered the bad debt loss in question.

Summary of Third Point

The courts' failure to find Petitioner was in the business of acquiring, owning, expanding, equipping, leasing and renting real estate was reversible error.

Although Petitioner introduced extensive evidence and urged in his brief to the Tax Court that he was engaged in the business of acquiring, owning, expanding, equipping and leasing bottling plants and other businesses, and introduced much evidence of the rental aspects of Petitioner's real estate business, the Tax Court failed to make any ruling on this point.

In addition to building the bottling plant and leasing it to Mission Orange Bottling Co. of Lubbock, Inc., as part of his over-all soft drink enterprise, Petitioner had a long history of acquiring property for rental purposes. In the years 1952 and 1953, in addition to the bottling plant, he was leasing a lumber yard site and a rent house which brought in net rentals of $15,570.58 in 1952 and $12,225.19 in 1953, plus operating a rental equipment corporation.

The facts show that Petitioner's loans to the debtor corporation were to a substantial degree induced by his renting to Mission Orange, and falls within the rule of *Maloney v. Spencer*[16] and should have been allowed a business bad debt deduction.

Summary of Fourth Point

If the Tax Court or the majority of the Court of Appeals for the Fifth Circuit had applied the correct legal standard to the facts of this case, Petitioner would have been allowed

[16] **Maloney v. Spencer,** (9 Cir.) 172 F. 2d 638; 49-1 USTC para. 9176

the $56,975.10 deduction as a business bad debt. The Tax Court and the Court of Appeals for the Fifth Circuit have applied too restrictive a legal standard in judging Petitioner's activities.

The Courts below held that for Petitioner's loss to be treated as a business bad debt he must show that he was either (1) in the separate business of buying and selling corporations; or (2) in the separate business of lending money; or (3) in the business of actually bottling drinks.

Petitioner engaged in a myriad of business activities, the cumulative effect of which clearly put them in the category of business activities as opposed to investment activities. The activities of the Petitioner in *organizing* and *managing* corporations, partnerships and joint ventures extended over a period of time from the commencement of his business career in 1941 to and including the year 1953 in which the loss was sustained.

The Tax Court's so-called findings of fact as to Petitioner's not being in a business as defined in Section 23(k) were really conclusions of law, based on incorrect legal standards, and hence are not binding on this Court. Had the proper rule of law been applied to the facts, as shown above, Petitioner would certainly qualify as having been in the business of regularly and continuously organizing and actively managing corporations.

The courts have recognized in the cases analyzed in detail in the First and Second Points that in order to organize, arrange for, and keep in touch with the financing of, coordinate the various activities of, and make the general policy decisions for a group of enterprises, as in Whipple's case, would necessarily take such extensive time, thought

and efforts of the taxpayer, separate and distinct from the business of each of the enterprises themselves, as to constitute a separate business distinct from that of the corporations themselves.

This is the basis for the distinction made by the cases between the activities of those who have organized and are managing and financing a number of corporations from those who merely invest or who manage and finance a single corporation.

Petitioner also engaged in extensive activities which go far beyond those of the ordinary organizer and manager of corporations. Petitioner consistently over a period of ten years financed the various partnerships, corporations and joint ventures in which he had an interest. The Courts took a narrow view in holding that because Petitioner's important business function of financing enterprises in connection with his activities of organizing and managing did not constitute a separate business of lending money, he was not entitled to take a business bad debt deduction.

Again, the Tax Court below took an overly restrictive view in considering only the bottling phase of his soft drinks enterprise, which was a part of his over-all business of organizing, financing, renting to, and managing corporations. The soft drinks enterprise, also included the ownership and renting of the building in which Mission Orange bottled the drinks, the organization of another corporation to distribute soft drinks, a soft drink vending machine business to further promote sales, and the personal ownership of the very franchise under which the Mission Orange drinks were bottled and sold.

Under the proper legal test laid down by the Courts, the bad debt in question was clearly the proximate result of the conduct of the soft drinks enterprise phase of Petitioner's business of organizing, financing, renting to, and managing corporations.

In addition to Petitioner's activities in organizing, managing and financing corporations, partnerships and joint ventures he supplied the plants and offices out of which all of these operated, and through this activity he generated substantial sums of ordinary income in the form of rents.

It is apparent from the record that Petitioner was regularly and continuously organizing, financing, renting to, and actively managing corporations. These activities were of the type which were reasonably calculated to, and in Petitioner, A. J. Whipple's case did, generate substantial amounts of ordinary income from sources separate and distinct from the conduct of the particular businesses of the corporations themselves, in the form of salaries, rents and interest. Had his soft drinks enterprise been a success, the income from all three of these sources would have undoubtedly been greater, and as a result of his efforts to make it so the $56,975.10 bad debt loss in question occurred. The error of the Courts in failing to so rule requires that this case be reversed and rendered.

First Point (Restated)

Congressional history shows that the addition of Section 23(k)(4) by the Revenue Act of 1942 was not intended to deny a busines bad debt deduction in the fact situation of this case.

A. Interpretation Clear 1942-1954

Prior to the Revenue Act of 1942, Section 124(a)[1], there was no distinction made in the Code between business and non business bad debts. The treatment accorded to bad debts was the same whether incurred in a trade or business or otherwise, and such bad debts were deductible in full. As the *House of Representatives Report No. 2333*, 77th Congress First Session, states in regard to the Revenue Act of 1942, at page 409 of Cumulative Bulletin 1942-2:

> "The present law gives the same tax treatment to bad debts incurred in non-business transactions as it allows to business bad debts. An example of a non-business bad debt would be an unrepaid loan to a friend or relative, while business bad debts arise in the course of the taxpayer's trade or business. This liberal allowance for non-business bad debts has suffered considerable abuse through taxpayers making loans which they do not expect to be repaid. This practice is particularly prevalent in the case of loans to persons with respect to whom the taxpayer is not entitled to a credit for dependents. The situation has presented serious administrative difficulties because of the requirement of proof."

The Senate Committee Reports contain no further explanation of the purpose for the insertion of the subsection which became 23(k)(4). At page 582 of 1942-2C.B., the Senate Report states about *Section 124 Deduction for Bad Debts, etc.*: "This Section is substantially the same as Section 119 of the House Bill." Then on page 574 the only difference is explained.[2]

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[1] 26 USCA, Sec. 23(k)(4) IRC 1939.

[2] "This section varies from the corresponding section of the House bill in that a loss resulting from the worthlessness of a non-business bad debt is to be considered a loss from the sale or

The Committee reports in both houses stated that the determination whether a debt is incurred in a trade or business "is substantially the same as that which is made for the purpose of ascertaining whether a loss from the type of transaction covered by Section 23(e) is incurred in trade or business under paragraph (1)[3] of that section." 1942-2 C.B., p. 573.

This relationship which the loan must have to a taxpayer's business was explained in the *House Committee Report* on page 431 of C.B. 1942-2 as follows:

> "* * * The character of the debt for this purpose is not controlled by the circumstances attending its creation or its subsequent acquisition by the taxpayer or by the use to which the borrowed funds are put by the recipient but is to be determined rather by the relation which the loss resulting from the debt's becoming worthless bears to the trade or business of the taxpayer. *If that relation is a proximate one in the conduct of the trade or business in which the taxpayer is engaged at*

exchange of capital asset held for not more than 6 months, rather than of a capital asset held for not more than 15 months. This change is made in view of corresponding changes made in section 136 of the House Bill (amending section 117 of the Code, relating to capital gains and losses) in order that losses resulting from the worthlessness of non-business bad debts may be treated in the same manner as short-term capital losses are treated under section 117 of the Code. In addition, the provisions with respect to non-business bad debts are now made applicable only to taxable years beginning after December 31, 1942." 1942-2, C.B. p. 574.

[3] 26 USCA, Section 23(e) IRC 1939: Losses by individuals. In the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise—

1. if incurred in trade or business; or
2. if incurred in any transaction entered into for profit, though not connected with the trade or business.

at the time the debt becomes worthless, the debt is not a nonbusiness debt for the purposes of this amendment." (Emphasis supplied)

The Committee then went on to give illustrations of debts which were incurred in what was obviously a business transaction to show how the time of the debt's becoming worthless would control in determining its proximate relationship to the taxpayer's business.

In a case involving the very first year of applicability of Section 23(k)(4), 1943, the question of how proximate the relationship of the debt to a business of the taxpayer must be was raised and decided in the case of *Cluett v. Commissioner*, 8 T.C. 1178 (1947) Acq. 1947-2 C.B. 2. In that case, the taxpayer sold a one-fourth ownership in a stock exchange seat for $125,000 and took a note from the purchaser for $65,000. The purchaser subsequently went bankrupt leaving $28,985.97 owing on the note. The taxpayer deducted this sum as a business bad debt, and in allowing this as a business bad debt the court said:

> "The principal contention of the respondent seems to be that the loss from the bad debt in question did not arise in the ordinary course of the operation of a business involving the buying and selling of stock exchange seats. The petitioner does not contend that he was regularly engaged in any such business. Neither does he contend that the loss in question was one sustained in a usual transaction of any partnership of which he was a member. He contends, however, that the loss resulted directly from the operation of the business in which he was regularly engaged, both at the time the sale was made and at the time the debt became worthless, and, in the alternative, that the loss was at least proximately related to or connected with that business. * * *.

> The legislative history of sec. 23(k)(4) indicates that its principal purpose was to place a limitation upon losses from bad debts, such as loans to relatives or friends which had no connection with the business of the lender. * * * .
>
> The debt here in question was not the result of a loan by the petitioner to a friend or relative or an isolated transaction which bore no relation whatsoever to the business in which he was engaged, but, on the contrary, was closely related to the business of owning and using a stock exchange membership for the production of income, in which busines, the petitioner was engaged not only in 1929, when the debt was created, but also in 1943, when it became worthless. * * *."

It is significant to note that the Treasury Department acquiesced in the *Cluett* interpretation of the statute, 1947-2 C.B.(2).

The next case to pass on the meaning of Section 23(k)(4) was that of *Campbell v. Commissioner*, 11 TC 510 (1948), involving the taxable year 1944.

The three petitioners in the *Campbell* case had been engaged since 1929 in organizing, owning and operating corporations engaged in the retail coal business, which totalled 12 such corporations. It was their practice as a part of their business to advance to (or leave with) those corporations on open account money belonging to them in many different instances. One of those corporations was the Campbell Bros. Coal Co. of Akron. The loans to that company which were in question were similar to loans made to other of their companies.

The court in determining that the loss resulting from such worthlessness was a business bad debt denied the govern-

ment's claim that taxpayer's loss fell under Section 23(k)(4), stating:

> "* * * They were debts, the loss from the worthlessness of which was incurred in the taxpayers' business. A finding has been made that they were business rather than nonbusiness bad debts because the evidence shows that they had a direct connection with the business carried on by these petitioners and the losses were directly a result of, and incurred in, the business of organizing and operating corporations engaged in the retail coal business, which business of *organizing and operating* such corporations was carried on by the petitioners during the taxable year. These are not cases in which losses of corporations are being confused with losses of individuals or in which the business of a corporation is being confused with the business of individuals. Nor are they like net loss carryover cases in which loss occurred in isolated transactions rather than in the operation of a business. * * *." (Emphasis supplied)

The Commissioner also acquiesced in this case decided in 1948, 1949-1 CB (1).

The Treasury's acquiescence in the *Cluett* and *Campbell* cases (supra) has never been withdrawn.

Closely following the *Campbell* case (supra) was the decision in the case of *Macy v. Commissioner*, 8 TCM 45, decided January 18, 1949, in which it was held that where a person invests in a number of businesses and *takes part in their management* over and above passively giving financial aid, he is in the business of investing and personally participating in various ventures and is entitled to claim a business bad debt deduction.

Petitioner in that case was engaged in the development of new business ventures and the organization and management of various corporations. In 1929 and 1930, he became interested in the development of a company for the manufacture of fountain pens and loaned substantial amounts of money to this company, which ultimately became bad debts. In holding that the petitioner's debt was a business bad debt within Sec. 23(k)(1) the court quoted from the case of *Foss v. Commissioner*, (1 Cir.) 75 F. 2d 326, 35-1 USTC, para. 9091, as follows:

> "The line comes between those who take the position of *passive investors*, doing only what is necessary from an investment point of view and those who associate themselves actively in the enterprises in which they are financially interested and devote a substantial part of their time to that work as a matter of business." (Emphasis supplied)

The "more than a passive investor" test of *Foss v. Commissioner* (supra) adopted by the Tax Court in the *Macy* case (supra) had been laid down in 1935 in a situation where the Commissioner, admitting that certain attorneys fees paid by the taxpayer were reasonable and necessary, had denied that they had been incurred "in carrying on any trade or business", under a Section of the Code which was substantially equivalent to Section 23(a)[4] of the 1939 Code existing at the time of the *Macy* decision.

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[4] 26 USC, Sec. 23 IRC 1939: Deductions from gross income. In computing net income there shall be allowed as deductions:
(a) Expenses.
(1) Trade or business expenses.
(A) In general. All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

The court in the *Foss* case in citing *Washburn v. Commissioner*, (8 Cir.) 51 F. 2d 949, 2 USTC, para. 794, with approval said:

> "In *Washburn v. Commissioner* (8th Cir.) 51 F. 2d 949, the petitioner's activities resembled those of Foss. He was a retired lawyer who gave his whole time to enterprises in which he had investments. It was held that he was engaged in business. We agree with that decision. A person of property, who devotes his time to the *active management of it* and also to active participation in the management of the companies in which his property is invested, and who maintains an office for that purpose where he spends a substantial part of his time, is carrying on business within the meaning of this statute." (Emphasis supplied)

Averill v. Commissioner, 20 BTA 1196, cited in the *Macy* case involved what constituted trade or business for the purpose of a loss carry-forward.[5]

The *Foss*, *Washburn* and *Averill* cases (supra) cited in the *Macy* decision were all ones involving sections of the Code other than 23(k)(4) and 23(e)(1), because at the

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[5] The taxpayer, Averill, was one of large resources, actively engaged in many businesses operated in his city who devoted the usual business hours of each day to his affairs, maintaining an office and employees. It was his practice to operate each business venture through a corporation and not a personal venture. Through the failure of one of such corporations, he sustained a loss in 1922. The court held: "He was not content merely to invest his money in stocks and bonds in corporations managed by others, taking the inactive interest generally shown by such investors. He directed his efforts to getting good men to manage the various enterprises in which he was interested and to so diversify and carry on the businesses that one would help another. He received salaries from several of these corporations as an officer, and he frequently consulted and advised with all of them. These activities constituted petitioner's business."

time, *Campbell v. Commissioner*, 11 T.C. 510, was the only decision involving the taxpayer's organizing, managing and financing of corporations under 23(k)(4) and there were apparently none under 23(e)(1).

Congress's intention in relating Section 23(k)(4) to Section 23(e)(1) was interpreted in the case of *Commissioner v. Smith* (2 Cir.) 203 F. 2d 310; 53-1 USTC para. 9317. There the taxpayer had no history of organizing corporations and admitted he was not in the business of lending money. However, he had advanced sums to several enterprises in which he had invested and tried to sustain his case on the broad definition of "business" in *Flint v. Stone Tracy Co.* 220 U. S. 107, 55 L. Ed. 389.

The court, in effect holding that such an interpretation would be a blurring of the distinction between Section 23(e)(1) and 23(e)(2) stated that Section 23(k)(4)'s definition of "business" was not the "transaction entered into for profit" referred to in Section 23(e)(2) and summarized the Congressional History as follows:

> "When in 1942 Congress amended Section 23(k) to provide for different treatment of nonbusiness bad debts from that accorded such losses when incurred in a trade or business, the committee reports in both houses stated that the determination whether a debt is incurred in a trade or business is substantially the same as that which is made for the purpose of ascertaining whether a loss from the type of transaction covered by section 23(e) is 'incurred in trade or business' under paragraph (1) of that section. 1942-2 Cum. Bull. 573. Section 23(e), dealing in general with losses sustained by individuals, explicitly establishes a distinction between losses incurred in trade or business and those stemming from 'any transaction entered into for profit, though

> not connected with the trade or business.' With this guide to the interpretation of Section 23(k), it becomes apparent that Congress did not adopt the broad definition of 'business' in *Flint v. Stone Tracy Co.*, 220 U.S. 107, 171, on which respondent relies."

On January 31, 1949, the Court of Appeals for the Ninth Circuit rendered a decision in the case of *Maloney v. Spencer*, (9 Cir.) 172 F. 2d 638; 49-1 USTC para. 9176, involving a question of whether an advance to a controlled corporation was a loss suffered in "the taxpayers trade or business."

In the *Maloney v. Spencer* case the taxpayer was the owner or lessee of three plants in which he carried on fruit, dairy and vegetable packing, canning and dehydrating operations. He formed three separate corporations to take over such operations, in which corporations he was the sole stockholder except for qualifying shares held by the Directors. In connection with his leases to these corporations, he provided financing of their operations through personal guaranty and pledge of property owned by him over a period of 3 years. The taxpayer improved the plants and spent about one-third of his time in performing activities as landlord.

In holding the taxpayer to be engaged in the business of acquiring, owning, expanding, equipping and leasing food processing plants, the court stated:

> "Here the taxpayer's activities were 'extensive, varied, continuous and regular' as in *Daily Journal Co. v. Commissioner*, 135 F. 2d 687, 688 (Cir. 9), and *Miller v. Commissioner*, 102 F. 2d 476 (Cir. 9). Here is the frequency and continuity of 'the transaction' resulting in a business status of *Commissioner v. Boeing*, 106 F. 2d 305, 319 (Cir. 9), cert. den. 308 U.S. 619. Here the taxpayer was engaged in two businesses as in *Daily*

Journal Co. v. Commissioner, supra, 689, and *Harvey v. Commissioner*, No. 11823, decided January 3, 1949 (Cir. 9). Like the instant case are *Fackler v. Commissioner*, 133 F. 2d 509 (Cir. 6); *Kales v. Commissioner*, 101 F. 2d 35 (Cir. 6); *Foss v. Commissioner*, 75 F. 2d 326 (Cir. 1).

"Here is the 'regularity' as distinguished from the 'isolated or occasional transactions' of *Burnet v. Clark*, 287 U.S. 410 424-5, and *Dalton v. Bowers*, 287 U. S. 404. Also is the multiplicity of transactions required by the several leases creating a business obligation to the corporations as distinguished from the 'single transaction' occurring in the 'lifetime' of the taxpayer 'but once' of *Deputy v. Dupont*, 308 U.S. 488, 495."

In September, 1950, the Tax Court rendered the decision of *Sage v. Commissioner*, 15 T.C. 299, in which the petitioner outlined many separate activities in which he participated from the time he graduated from college in 1923 until about 1946. The court found he was always looking for opportunities to use his money and time. Some proved to be profitable, but most did not. The loans to Revenue Development Corporation, the subject of the bad debt loss, the court found were:

"like his aid to or investment in a number of other business ventures—each was accompanied by activity of the petitioner in the venture. This is not a case, like *Higgins v. Commissioner*, 312 U.S. 212, of a wealthy man claiming that the investing and reinvesting of a large fortune in marketable securities constitutes carrying on a business. The petitioner, no doubt, did some investing and reinvesting of his funds in marketable securities, but he does not refer to that part of his activities as a basis for his claim here. He mentions only

> ventures of a different character in which he assumed greater risks and in which he actually participated, or hoped to participate through personal services. * * * He did not merely invest his money but used his time and energy to make the venture succeed."

In allowing the petitioner Sage the deduction, the court stated "He did that sort of thing with such frequency and regularity that it amounted to a regular business carried on by him" and went on to state:

> "The working assets of his business were his money and his personal services. He used them consistently and repeatedly. If one venture was successful, he continued with it, but if it failed, he dropped it. He continued to look for other opportunities. His business was not merely that of a particular venture. Cf. *Burnet v. Clark*, 287 U. S. 410. He was *not a passive investor*. The Revenue Development Corporation venture was not an isolated transaction but was a part of his regular business and the loss from that venture was incurred in *the operation of a business regularly carried on by him*. Cf. *Washburn v. Commissioner*, 51 F. 2d 949; *T. I. Crane*, 17 B.T.A. 720." (Emphasis supplied.)

The *Sage* case was acquiesced in by the Commissioner, 1951-1 CB 3.

Another case decided upon the law as it existed immediately prior to the passage of the Revenue Act of 1954 as to what constitutes a trade or business under Section 23(k)(4) was *Commissioner v. Stokes' Estate*, (3 Cir.) 200 F. 2d 637, 53-1 USTC para. 9164, decided in January 1953. The court held that the taxpayer's loss suffered from a loan to one of the corporations he had formed was a business bad

debt within Sec. 23(k)(1) and characterized his activities in organizing, investing in and managing corporations as follows:

> "It was quite clearly a personal activity in which a major portion of the decedent's lifetime, thought and energy was enlisted and in which he engaged continuously and regularly throughout his business career. In these respects this case differs from those relied on by the Commissioner and resembles *Maloney v. Spencer*, (9 Cir.) 1949, 172 F. 2d 638, 640; *Vincent C. Campbell v. Commissioner*, 1948 11 T.C. 610, acq. 1949-1 C.B. 1; and *Henry F. Sage v. Commissioner*, 1950, 15 T. C. 299, acq. 1951-1 C.B. 3, in which cases activities in many respects similar to those here were held to be business activities. And see *Robert Cluett, 3rd v. Commissioner*, 1947, 8 T.C. 1178, acq. 1947-2 C.B. 2."

Therefore, at the time of the enactment of the Internal Revenue Code of 1954, a complete revision of the tax law both as to substance and form, the courts had consistently recognized that the activities of a taxpayer in regularly and continuously organizing and actively managing corporations constituted the carrying on of a business within the meaning of Section 23(k).

Or in other words, to use the test, laid down by *Foss v. Commissioner*, (1 Cir.) 75 F.2d 326, 35-1 USTC para. 9091, as quoted in *Macy v. Petitioner*, 8 TCM 45; again reiterated in *Sage v. Commissioner*, 15 T.C. 299, and in essence followed in *Commissioners v. Stokes' Estate*, 200 F. 2d 637, 53-1 USTC para. 9164, the question is whether the taxpayer is *"more than a passive investor"*.

B. Enactment of Internal Revenue Code of 1954 Confirmed Prior Decisions

The reenactment by Congress without significant change of Sections 23(k)(1) and 23(k)(4) into Sections 166(a)[6] and 166(d)[7] of the Internal Revenue Code of 1954 could certainly be considered as a clear affirmation of the "more than a passive investor" rule first laid down in the *Foss*[8] case and the interpretation given Section 23(k) by the *Campbell*[9], *Macy*[10], *Sage*[11] *Maloney*[12], and *Stokes*[13], decisions.

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[6] Subsection (a) contains the general rule for the treatment of bad debts found in section 23(k)(1) of the 1939 Code. No substantive change is made.

[7] The only substantive change was made to liberalize the allowance of business bad debt treatment. (83d Cong., 2d Sess., S. Rep. No. 1622 (1954) 199): "Subsection (d) relating to nonbusiness bad debts of taxpayers other than corporations incorporates provisions contained in section 23(k)(4) of the 1939 Code with certain substantive changes. Nonbusiness bad debts continue to be treated as short-term capital losses. Two types of indebtedness are specificially excluded from the definition of nonbusiness bad debts. First, debts which become worthless in the course of the trade or business of the taxpayer. This is the only type of indebtedness which was excluded from the definition of nonbusiness bad debt under existing law. Second, any debt which is either created in the course of the trade or business of the taxpayer or is acquired by him in the course thereof without regard to the relationship of the debt to a trade or business of the taxpayer at the time that the debt becomes worthless, shall not be treated as a nonbusiness bad debt."

[8] 75 F. 2d 326, 35-1 USTC para. 9091.

[9] 11 TC 510.

[10] 8 TCM 45.

[11] 15 TC 299.

[12] 172 F. 2d 638, 49-1 USTC para. 9176.

[13] 200 F. 2d 637, 53-1 USTC para. 9164.

One of the first cases decided after the enactment of the 1954 Code, *Scott v. Commissioner*, 14 TCM 1029, T. C. Memo 1955-258, decided September 16, 1955, allowed a business bad debt deduction to a taxpayer who had formed and loaned money to some 12 or 13 corporations to one of which he made the loan which was the subject of the bad debt in question, citing as authority *Sage v. Commissioner*, 15 T.C. 299; *Campbell v. Commissioner*, 11 T.C. 510; *Maloney v. Spencer*, 172 F. 2d 638; 49-1 USTC para. 9176.

In the case of *Giblin v. Commissioner*, (5 Cir.) 227 F. 2d 692; 56-1 USTC para. 9103, decided November, 1955, the Court of Appeals for the Fifth Circuit, in reversing the Tax Court's holding that the petitioner was not engaged in business within the meaning of Section 23(k)(4), stated:

> "Both the Tax Court and Courts of Appeals have recognized the type of activity engaged in by petitioner as satisfying the requirement of 'carrying on a trade or business' when such activity has been sufficiently extensive to warrant the conclusion that the individual involved is *more than a passive investor. Foss v. Commissioner of Internal Revenue*, (1 Cir.) 76 (75) F. 2d 326; *Maloney v. Spencer*, (9th Cir.) 172 F. 2d 638; *Commissioner of Internal Revenue v. Stokes' Estate*, (3 Cir.) 200 F. 2d 637; *Henry E. Sage v. Commissioner of Internal Revenue*, 15 T.C. 299; *Charles H. Scott and Wife v. Commissioner of Internal Revenue*, 14 T.C. 1029, decided September 16, 1955." (Emphasis supplied)

A year later this Honorable Court decided the case of *Putnam v. Commissioner*, 352 U.S. 82; 1 L.Ed. 2d 144, which as far as we know is the only other time that it has

been called upon to pass upon Section 23(k)(4) IRC 1939. Whereas there the facts and the issues[14] were so different as to prevent the holding from being applicable to the case before the Court now, its comments on the legislative history of the Section of course should be given full consideration. The Court said:

> "The section was part of the comprehensive tax program enacted by the Revenue Act of 1942 to increase the national revenue to further the prosecution of the great war in which we were then engaged. It was also a means for minimizing the revenue losses attributable to the fraudulent practices of taxpayers who made to relatives and friends gifts disguised as loans. Equally, however, the plan was suited to put non-business *investments* in the form of loans on a footing with other non-business *investments.*" (Emphasis supplied)

In December, 1959, the Court of Appeals for the Sixth Circuit in the case of *Mays v. Commissioner* (6 Cir.) 272 F. 2d 788; 60-1 USTC para. 9122, in reversing the Tax Court, held that loans to corporations operating retail outlets made by the taxpayers in order to expand their wholesale cigar distributing corporations were business bad debts within the meaning of Section 23(k).

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[14] In the Putnam case the question was whether a loss occasioned by the taxpayer, a lawyer who showed no history of organizing, managing or financing corporations but who had guaranteed an obligation of a publishing corporation which he had formed, was to be treated as a bad debt under Section 23(k)(4) or as a loss sustained in a transaction entered into for profit not connected with business under Section 23(e)(2). Rev. Rul. 60-48, 1960-1 CB112, makes it clear that the **Putnam** decision merely stands for the proposition that a noncorporate guarantor of a corporate indebtedness has a bad debt deduction, rather than an ordinary business loss, and that the question of whether the payment of the guaranty results in a business or a nonbusiness bad debt is dependent upon the facts of each case. 63 CCH par. 1627.461.

The Court in so holding stated the rule of law as follows:

> "Mere participation in a corporate venture by owning stock, as an investment, does not place one in the business which the corporation carries on. An individual taxpayer is not allowed to override the corporate entity and take unto himself the tax benefit of Section 23(k)(1), unless the debt bears a proximate relationship to the taxpayer's own true business as distinguished from that of the corporation. *Commissioner v. Stokes' Estate*, 200 F. 2d 637 (C.A. 3). But, where a person invests in a number of entities appertaining to his own business and takes part in their management beyond passively giving financial aid, a bad debt loss to one of the businesses is incident to his regular vocation and is not the result of an isolated investment."

The Court also cited as authority for its holding *Maloney v. Spencer*, (9 Cir.), 172 F. 2d 638, 49-1 USTC para. 9176 and *Campbell v. Commissioner*, 11 T.C. 510.

In the recent case of *Maytag v. U. S.* (U. S. Court of Claims, 1961), 289 F. 2d 647, 61-1 USTC para. 9424, the Court of Claims held that the taxpayer had suffered a business bad debt loss in a transaction which the taxpayer described as being "one feature of his general business of carrying on activities connected with the airplane industry" The Court in holding for the taxpayer stated:

> "Since 1947, when he was 21 years old, the plaintiff has been engaged solely in business connected with aviation * * *. During the years 1951 to 1956 the plaintiff caused four other corporations to be formed. Their nature is described in finding 8. Their activities were exclusively in the field of aviation and aviation equipment.

"* * * They show, we think, that the plaintiff's business was a myriad of activities, all directly connected with aviation, which could be owned as elatively small business enterprises without involving outside capital in large amounts. The plaintiff, for reasons satisfactory to him carried on these enterprises in corporate form. He was not involved in these corporations merely as an investor * * *. Our conclusion is that these activities were his business and the bad debt which he seeks to deduct was a business bad debt."

In each of the foregoing cases[15] decided since the enactment of the 1954 Code, the "more than a passive investor" rule of *Foss v. Commissioner* (1 Cir.), 75 F. 2d 326, 35-1 USTC para. 9091, was recognized and acknowleged to be the test of whether the taxpayer was carrying on a trade or business. However, due to the insertion of some unfortunate and superfluous language as dicta in *Giblin v. Commissioner* (5 Cir.), 227 F. 2d 693, 56-1 USTC para. 9103, the Courts of Appeals of two Circuits, and certain of the later Tax Court cases, have commenced the imposition of an additional requirement, namely that the taxpayer must have organized the corporations for sale. This was not contemplated by Congress and makes a radical departure from established law.[16]

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[15] See also **Glenn Alexander v. Commissioner,** 71 TC 758, decided July 29, 1960 which cited **Campbell v. Commissioner,** 11 TC 510 with approval.

[16] **Campbell v. Commisioner,** 11 TC 510.
Maloney v. Spencer, (9 Cir.) 172 F. 2d 638, 49-1 USTC para. 9176.
Macy v. Commissioner, 8 TCM 45.
Sage v. Commissioner, 15 TC 299.
Commissioner v. Stokes' Estate, (3) Cir.) 200 F. 2d 637, 53-1 USTC para. 9164.
Scott v. Commissioner, 14 TCM 1329, TCMemo 1955-278.

Second Point (Restated)

The majority of the Court of Appeals for the Fifth Circuit erred in affirming the holding of the Tax Court that the taxpayer in order to deduct as a business bad debt one of many loans made in the course of his extensive activities in organizing, managing and financing numerous corporations, must also prove that he was a person who had formed the corporations for the purpose of selling them.

The basic error of the Tax Court, which was affirmed by the Court of Appeals in the case below, was its holding that Petitioner, A. J. Whipple, in order to deduct as a business bad debt one of many loans in the course of his business of organizing, managing and financing numerous corporations, must also prove that he was a *promoter* who had formed the corporations for the *purpose of selling them.*[1]

Such a rule, as was shown in detail under the First Point was not the intent of Congress, is in conflict with the decision in every case decided from the date of the enactment of Section 23(k)(4) to June, 1958, and is contrary to the great weight of authority since that time.

In all of the following cases business bad debt treatment was allowed to a taxpayer who showed no evidence whatever of having formed corporations for sale: *Campbell v. Commissioner*, 11 T.C. 510; *Mays v. Commissioner*, (6 Cir.) 272 F. 2d 788, 60-1 USTC para. 9122; *Maloney*

[1] See statement by the Tax Court (R. 31) that Petitioner did not "* * * develop them for sale as a going business to customers in the course of the business of promoting."

v. Spencer, (9 Cir.) 172 F. 2d 638, 49-1 USTC, para. 9176; *Commissioner v. Stokes' Estate*, (3 Cir.) 200 F. 2d 637, 53-1 USTC, para. 9164; *Sage v. Commissioner*, 15 TC 299; *Scott v. Commissioner*, 14 TCM 1029; *Alexander v. Commissioner*, 34 TC 758; and the recent cases of *Trent v. Commissioner* (2 Cir.), 291 F. 2d 669, 61-2 USTC para. 9506, reversing 34 TC 910 and *L. B. Maytag, Jr. v. U. S.* (U. S. Court of Claims), 289 F. 2d 647, 61-1 USTC para. 9424. Also see the case of *Giblin v. Commissioner* (5 Cir.), 227 F. 2d 692, 56-1 USTC para. 9103.

These cases, for the most part, were based on the earlier rule laid down in *Washburn v. Commissioner* (8 Cir.), 51 F. 2d 949; 2 USTC para. 794; allowing a net operating loss carry forward from 1922 to the year 1923 and *Foss v. Commissioner* (1 Cir.), 75 F. 2d 692; 35-1 USTC para. 9091, allowing a deduction of certain expenses as being incurred in the business of actively participating in the management of a number of corporations. Neither were cases of taxpayers who formed corporations for sale.

Apparently the Tax Court's mistake stems from its reliance on the case of *Holtz v. Commissioner*, (9 Cir.), 256 F. 2d 865, 58-2 USTC para. 9620.

The findings of the Tax Court, which were affirmed by the Court of Appeals, in the *Holtz* case (supra) as "not being clearly erroneous" were:

> "We do not think that the activities outlined herein are sufficiently extensive to establish the existence of a separate business of promoting, organizing, financ-

ing and managing businesses during 1950." 16 TCM 439.

The Court of Appeals in that case seized on the word "*promoting*" used by the Tax Court and treated it as being controlling, when in fact the controlling words in the Tax Court's holding were "We do not think that the activities outlined herein are sufficiently extensive *to establish the existence of a separate business.*"[2]

In distinguishing the cases which the petitioner was relying on, the Court of Appeals in the *Holtz* case (supra) made the following statement:

> "Petitioner relies on the line of cases which holds that a stockholder's loan to one of his corporations may qualify as a business bad debt if the stockholder was engaged in *promoting*, organizing, financing and managing business enterprises, or in other words was en-

[2] It would appear that the Tax Court in this Whipple case below was following the same erroneous reasoning when it made the statement:

> "What petitioner fails to recognize is the distinction between carrying on one's business through a corporate form, which, of course, requires some organizing and financing, and the business of dealing in corporations, which may likewise require some financing arrangements. **Holtz v. Commissioner,** (C.A. 9) 256 F. 2d 865, 870, affirming T.C. Memo. 1957-106."

It might be more accurately stated what the Tax Court failed to recognize is the distinction drawn in the numerous cases cited in the First Point between the business of organizing, managing and financing corporations separate and distinct from the corporation and the particular business being conducted by the corporation itself. **Campbell,** 11 TC 510, **Scott,** 14 TCM 1029, TC Memo 1955-258, **Sage,** 15 TC 299, **Macy,** 8 TCM 45, **Averill,** 20 BTA 1196, **Stokes',** 200 F. 2d 637, 53-1, USTC para. 9164, **Giblin,** 227 F. 2d 692, 56-1 USTC para. 9103, **Mays,** 272 F. 2d 788, 60-1 USTC para. 9122, **Alexander,** 34 TC 758, following the rules of **Foss,** 75 F. 2d 326, 35-1 USTC para. 9091.

gaged in the business of being a *promoter*. Petitioner unsuccessfully seeks to bring himself within the facts of certain of the *promoter* cases. Each of those cases is distinguishable."

The Court then proceeded to misinterpret the long standing decision of *Campbell v. Commissioner*, 11 TC 510 (1948).[3] Actually the Court in the *Holtz* case went so far as to misquote the opinion of the court in the *Campbell* decision as follows:

> "And in Campbell v. C.I.R., 1948, 11 T.C. 510 (CCH Dec. 16, 611), there was an express finding that the taxpayers were engaged in the business of *promoting*, financing, organizing and managing corporations to operate coal mines and therefore loans to the corporations were in the taxpayers' trade or business of promoting. * * *" (Emphasis supplied).

In not a single line of the whole opinion of *Campbell v. Commissioner* (supra) does the word 'promoting' appear. To the contrary, the court found that the bad debt loss

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[3] In **Campbell v. Commissioner**, the Court found that the loss on a loan made to one of twelve corporations organized by the taxpayer to engage in the retail coal business was a business bad debt stating:

> "They were business rather than nonbusiness bad debts because the evidence shows that they had a direct connection with the business carried on by these petitioners and the losses were directly a result of, and incurred in, the **business of organizing and operating corporations** engaged in the retail coal business, which business of organizing and operating such corporations was carried on by the petitioners during the taxable year. These are **not** cases in which losses of corporations are being confused with losses of individuals or in which the business of corporations is being confused with the business of individuals." (Emphasis supplied).

suffered by Campbell was incurred by one in the business of organizing and *operating* corporations.

The Court of Appeals in *Holtz v. Commissioner* (supra) seized upon similar loose language used as dictum in *Giblin v. Commissioner*, (5 Cir.) 227 F. 2d 692, 56-1 USTC para. 9103, to distinguish it as follows:

> "The *Giblin* case contains a clear finding of fact that the taxpayer was engaged in the business of 'seeking out business opportunities, promoting, organizing and financing them, contributing to them substantially fifty percent of his time and energy and then *disposing of them at a profit or loss.*'"

Then again, the Court citing from a *footnote* in the case of *Pokress v. Commissioner*[4] said:

> "As the Fifth Circuit recently said in distinguishing the *Giblin* case 'Petitioner was not engaged in the business of *dealing in enterprises*. Pokress v. CIR.'"

This conclusion that "dealing in enterprises" means forming corporations for sale seems to be arrived at by the reasoning that "dealing" implies "dealer" and "dealer" implies "selling". This is rather tenuous reasoning to use as the basis for the upsetting of a long established and sound legal standard.

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[4] (5 Cir.) 234 F. 2d 146; 56-2 USTC para. 9610. Actually the **Pokress** case (supra) was one involving a taxpayer who had found himself forced into investing in one corporation and later to lending it money to protect his investment. There was no evidence of his ever having formed a corporation at all and was indeed not a "dealer in enterprises" by any definition and certainly not a person engaged in managing corporations.

As can be seen, the other cases relied upon by the Tax Court below were the result of this same misinterpretation and basic error in application of the correct legal principles.

The second decision cited by the Tax Court below, *H. Beale Rollins*, 32 T.C. 604, aff'd (4 Cir.) 276 F. 2d 368, 60-1 USTC para. 9357, contains the following language:

> "* * * At no point is there any indication that petitioner considered *disposing* of any one of the segments of this profitable enterprise following their successful 'promotional' or organizational phase * * *." (Emphasis supplied).

Further evidence of the confusion incident to the erroneous interpretation of the holding in the *Giblin* case (supra) is demonstrated by the opinion of the Court of Appeals for the Fourth Circuit in *Rollins v. Commissioner* (4 Cir.) 276 F. 2d 368, 60-1 USTC para. 9357.[5]

In the next case relied on by the Tax Court below, *Vreeland v. Commissioner*, 31 TC 78, in an opinion

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[5] The decision of the Tax Court in that case was cited by the Tax Court in this case below as requiring that the corporations organized, financed and managed by the taxpayer must have been developed for sale. While basing its affirmance upon other grounds, the Court of Appeals for the Fourth Circuit in the **Rollins** case approved such a requirement only as an element to be considered rather than as a **controlling** test, saying:

> "Moreover, unlike the **Giblin** case, the Tax Court here pointedly noted the absence of evidence that the taxpayer had ever disposed of any business either at a profit or loss, after completing his asserted promotional and organizational activities —a circumstance that is not controlling but is entitled to consideration."

by the same justice as in this case below, the Tax Court showed it was also following the same erroneous thinking, by the statement:

> "* * * Had he done so (had the intent to build up corporations and eventually dispose of them) they would have been held by him *for sale* to customers in the ordinary course of his business." (Emphasis supplied)

Since the Court of Appeals in *Holtz v. Commissioner* (9 Cir.) 256 F. 2d 865, 58-2 USTC para. 9620, interpreted the case of *Giblin v. Commissioner* (5 Cir.) 227 F. 2d 692; 56-1 USTC para. 9103, to be based on the taxpayer's being in the business of promoting, organizing and financing corporations, and then "disposing of them at a profit or loss", Petitioner secured the complete transcript of the *Giblin* case to determine what the facts of the *Giblin* case really were. The record and the opinion of the *Giblin* case do not show that the decision was based on the grounds set forth in the *Holtz* (supra) opinion.

First, Petitioner submits that it is incorrect to state that there was such a finding of fact by the Court in the *Giblin* case.

Taxpayer's petition to the Tax Court, which as one of the attorneys of record he presumably had a part in drafting, stated: "Petitioner was * * * engaged in organizing, financing, managing and operating corporations and other enterprises so as to constitute a business". Nowhere does such petition mention "promoting", but even if after all the evidence were in the court found the word "promoter" to be a proper one to describe Mr. Giblin, it does not mean that he must have promoted these enterprises for sale. He could

have (and in fact did) promote them "to provide himself with an avenue of escape from the practice of law". This implies a desire to find a business which would provide him with a permanent source of income that would make it unnecessary for him to keep working at the law.

Whereas, the record shows that Giblin's interests in a few enterprises organized by him were sold at a profit, and the disposal of some others were forced on him by losses. *Nowhere in his eleven pages of testimony before the Tax Court* did he state an intent of having formed such enterprises for sale. Furthermore, six, including the one in which he suffered the loss in question, of the most important of Giblin's businesses mentioned in the opinion appear to have been formed to operate, and another one did not involve sales.[6]

The Court in the *Giblin* case, was certainly not laying down the requirement that corporations must be formed *for sale* as the correct legal standard when it stated:

> "Both the Tax Court and the Courts of Appeals have recognized the type of activity engaged in by petitioner as satisfying the requirement of 'carrying on any trade or business' when such activity has been sufficiently extensive to warrant the conclusion that the individual involved is *more than a passive investor.*" (Emphasis supplied) Citing *Foss v. Commissioner*, (1 Cir.), 75 F. 2d

[6] Furthermore, an examination of the record in the **Giblin** case shows that nearly all of his ventures were failures and that he disposed of them in the same manner as Petitioner, by realizing what he could from their liquidation. His two profitable ventures were put out of business by a change in the State law. These also were forced liquidations. The record in **Giblin** fails to show that he disposed of any profitable enterprises voluntarily, except stock in one corporation owning a lease, which was sold to an associate. The entire record shows that Giblin sold only to terminate a losing venture or one no longer legal.

326, 35-1 USTC Para. 9091, *Maloney v. Spencer*, (9 Cir.) 172 F. 2d, 638, 49-1 USTC para. 9176, *Commissioner v. Stokes' Estate*, (3 Cir.) 200 F. 2d 637, 53-1 USTC para. 9164, *Sage v. Commissioner*, 15 TC 299; and *Scott v. Commissioner*, 14 TCM 1029, TC Memo 1955-258."

Not one of these cases cited involved the formation of a corporation for sale.

In spite of this, the majority of the Court of Appeals for the Fifth Circuit in this case below affirmed the erroneous rule of law used by the Tax Court by citing (R. 135) the language of the *Giblin* (supra) and *Holtz* (supra) cases to the effect that Petitioner, A. J. Whipple, was not in the business of "disposing of his corporations at a profit or loss" nor a "dealer in enterprises" as a basis for it decision.

Whether it was the holding of *Giblin v. Commissioner* (supra) or its misinterpretation by the Court in *Holtz v. Commissioner* (supra) or the language in the footnote in *Pokress v. Commissioner* (supra) this imposition of the requirement that the corporations be organized for sale results in the addition of a new criteria never before appearing in any of the cases involving the question of whether the taxpayer was engaged in trade or business, from *Washburn v. Commissioner* (8 Cir.) 51 F. 2d 949, 2 USTC para. 794, decided in August, 1931, to *Giblin v. Commissioner* (supra) decided in November, 1955.

Or as Judge Hutcheson puts it so well in his dissent (R. 142):

> "Yet the government contends, and the Tax Court and the majority have erroneously held, that in order for a loss to be deductible, taxpayer Whipple must show

that the numerous corporate enterprises which he promoted, financed and managed, were formed by him for sale. This extension of the restriction on the qualification of business bad debts contended for by the Commissioner and the Tax Court considerably restricts the remedy which Congress provided for curing the mischief it had in mind. I think it clear that such restriction was never contemplated by Congress. Indeed the contention pressed here emasculates a clearly intended remedial law.

Looking at the question in the light of the language of the act and its legislative history, I am in no doubt that the Tax Court was wrong in citing and relying on cases to the contrary of these views for such a restrictive and defeating construction."

The extent of the Court's departure from the established rule is also pointed up by Judge Hutcheson in the concluding paragraph of his dissent where he stated (R. 143):

"It seems to me that the basic fault of the majority opinion is in holding, as it in effect does, that business bad debt treatment must be denied the taxpayer here because the loan was to a corporation in which he was interested. This holding is, in my opinion, a clear addition to the taxing statute. If congress had so intended, it could and would have so provided. Not having done so, neither the tax court nor this court can construe the statute as though it contained such provision."

Such is certainly not the law, and the case of *Scott v. Commissioner*, 14 TCM 1029, TC Memo 1955-258, is authority for the contrary.[7]

[7] See also **Campbell v. Commissioner**, 11 TC 510, **Maloney v. Spencer**, (9 Cir.) 256 F. 2d 865, 49-1 USTC para. 9620, **Sage v. Commissioner**, 15 TC 299, and **Mays v. Commissioner**, (6 Cir.) 272 F. 2d 778, 60-1 USTC para 9122.

This narrow thinking of requiring that corporations be formed *for sale* accounts for the Tax Court making so much of the fact that Petitioner in a prior year, 1951, had treated the sale of his equity interests in fourteen partnerships and corporations to his partner, at book value, as a capital gain, and for making the erroneous conclusion that he should necessarily, therefore, treat the losses suffered in 1953 from *loans* on open account made to entirely different corporations as capital losses. In comments made at the end of the trial (R. 127) the court said:

> "But primarily, the result of being in a business is the creation of ordinary income. It may be through salaries or it may be through the purchase and sale of property.
>
> "When as a result of a business it's the acquisition, properties acquisition in connection with the business, there is a sale, there is normally an ordinary gain and loss and not a capital. I don't imagine there would be anything further you want to ask this witness, but I gathered the impression that when the property was sold to which you referred that he acquired around 1949, 1950, and so on, that it was treated as capital gain, whereas, in the case of a true promoter, he makes his money either by being hired to do the promoting by some syndicate or other, from which he gets a salary and, therefore, the tax is ordinary income; or he makes his money by buying into interests and trying to sell them at a profit, in which case he would do so at ordinary income rates."

Then, in the opinion, the court states (R. 31):

> "* * * His purpose in forming the fourteen corporations was to facilitate his construction or real

estate business and not to develop them for sale as going businesses to customers in the course of the business of promoting, *H. Beale Rollins*, 32 T.C. 604, 615. Petitioner apparently entertained that opinion himself in the year 1951, when in his return for that year he reported the sale of twelve corporations and one partnership as a sale of capital assets. See *Thomas Reed Vreeland*, 31 T.C. 78. The evidence does not show that petitioner's business in 1953 was any different from 1951."

Petitioner's equity interests, in the form of stock in the many corporations and capital accounts in the partnerships which he sold to a dominant partner in 1951 in what he described as an across the board "liquidation" (R. 94) of his interests, many of which he had owned for as long as eight or nine years, were made as permanent investments as a part of his overall business activities.

It might be well to point out here that the taxable year 1951 is not in question in this proceeding. In any case, it most certainly does not follow that losses suffered in 1953 from loans to one of any entirely new set of corporations organized by him after the 1951 liquidation must necessarily be capital losses.

In the process of petitioner's organizing, financing and lending money, and operating corporations, he used his money in two ways. One was to buy stock as a permanent investment. The other was to *lend money temporarily* with the idea it would be *taken out and used again* in his business of organizing, financing, lending money to, and operating corporations and partnerships. This country has millions of permanent investors in stock in corporations, but they do not ordinarily lend these corporations money,

certainly not on open account. If they do, it is customarily in the form of a bond. Petitioner had a number of stockholders with permanent investments in his corporations and partnerships, but he was the *only* stockholder who the record shows loaned these 1951-1953 corporations and partnerships money. He was the one who furnished the real financing along with his activities in organizing and managing these corporations and partnerships. In doing so, he was certainly *more than a passive investor*.

Whatever Petitioner's intentions may have been as to the sale of Mission Orange Bottling Co., had it been successful, certainly his extensive activities from 1951 forward in putting together enterprises, forming corporations and financing and actively operating them were much more than those of a *passive investor*, and, as such, constituted a business, out of the conduct of which the $56,975.10 bad debt loss resulted.

Finally, the Tax Court erred in its thinking where, in its comments at the end of the trial (R. 127), it seemed to be limiting the possibility of a taxpayer's being in a trade or business, by requiring him to show that he was creating one of two types of ordinary income, stating:

> "It may be through salaries and it may be the purchase and sale of property."

Then later in its opinion the court limited it still further, to a showing of only one type of ordinary income, namely the proceeds from property which had been held for sale. (R. 31) Such a narrow ruling, we reiterate, is wrong as a matter of law. For instance, there are at least two other types of ordinary income that can be created as part of a business—interest and rental income.

The true test therefore is whether Petitioner was an investor who expected his investments to earn him a return, or was actively engaged in business activities from which he sought to create income from salaries, from interest, or from rent. The record shows that Petitioner, A. J. Whipple, was instrumental in generating income from all three.

Third Point (Restated)

The majority of the Court of Appeals for the Fifth Circuit and the Tax Court erred in failing to find that Petitioner was in the business of acquiring, owning, expanding, equipping, leasing and renting real estate out of the conduct of which business the $56,975.10 bad debt resulted.

In the second paragraph of the opinion of the Tax Court below it is stated (R. 30):

> "Petitioner would have us find proximate relationship between the loss occasioned by the worthlessness of the debt due from Mission Orange and any one of three businesses in which he alleges he was individually engaged at the time of the loss. He contends that he was in the business of organizing, promoting, managing and financing corporations, general financing and lending of money, operating a bottling business, or all three."

In Petitioner's brief to the Tax Court the third point of argument relied upon was stated as follows:

> "Petitioner was engaged in the business of acquiring, owning, expanding, equipping and leasing bottling plants and other businesses."

And there was strong evidence to support such a proposition. In Petitioner's brief the close similarity between taxpayer, A. J. Whipple's case and that of the taxpayer in *Maloney v. Spencer*, (9 Cir.) 172 F. 2d 638, 49-1 USTC para. 9176 was brought out in detail. Yet, the Tax Court below completely ignored this theory of recovery.

The facts of th. leading case of *Maloney v. Spencer*, (supra) parallel those of the instant case very closely.

1(a) In *Maloney v. Spencer* the taxpayer organized three fruit, berry and vegetable packing and canning and dehydrating corporations, owned almost entirely by taxpayer, which operations were previously conducted by taxpayer individually.

1(b) In the instant case Petitioner organized a soft drink bottling corporation (R. 27) and later a soft drink distributorship corporation (R. 112-114) and a soft drink vending machine business (R. 114-115). Petitioner was the controlling and dominant owner of all three of these. (R. 27; R. 112-115).

2(a) In *Maloney v. Spencer* to further equip one plant the taxpayer bought adjoining land, and erected buildings equipped for canning, and leased it to the cannery corporations.

2(b) In the instant case, Petitioner bought land in the same city and erected a building on it, equipped it for bottling soft drinks, and leased it to the bottling corporation. (R. 28)

3(a) In *Maloney v. Spencer* the taxpayer agreed as part of the lease to provide adequate financing for the cannery business.

3(b) When Petitioner built his building for the bottling plant, he was already providing the bottling corporation with financing, having advanced $69,002.50, and it was implicit in the lease that he would continue to do so, which he did, in the amount of an additional $62,775.76.

4(a) In the case of *Maloney v. Spencer*, the taxpayer extended credit to the debtor corporation in numerous transactions, over a period of three years resulting in a balance of an open account that became the bad debt in question.

4(b) In the instant case Petitioner, A. J. Whipple, extended credit to the debtor corporation in numerous transactions, over a period of three years resulting in a balance of an open account that became the bad debt in question.

The court in the case of *Maloney v. Spencer* held that the taxpayer was engaged in the business of acquiring, owning, expanding, equipping, and leasing food processing plants, and stated:

> "Here the taxpayer's activities were 'extensive, varied, continuous and regular' as in *Daily Journal Co. v. Commissioner*, 9 Cir. 135 F. 2d 687, 688, and *Miller v. Commissioner*, 9 Cir. 102 F. 2d 476. Here is the 'frequency and continuity of the transaction resulting in a business status' of *Commissioner v. Boeing*, 9 Cir., 106 F. 2d 305, 319. certiorari denied, 308 U.S. 619, 60 S. Ct. 295, 84 L. Ed. 517. Here the taxpayer was engaged in two businesses as in *Daily Journal Co. v. Commissioner*, supra, 135 F. 2d 689, and *Harvey v. Commissioner*, 9 Cir., 171 F. 2d 952. Like the instant case are *Fackler v. Commissioner*, 6 Cir., 133 F. 2d 509; *Kales v. Commissioner*, 6 Cir., 101 F. 2d 35, 122, A.L.R. 211; *Foss v. Commissioner*, 1 Cir., 75 F. 2d 326.

> "Here is the 'regularity' as distinguished from the 'isolated or occasional transactions' of *Burnet v. Clark*, 287 U.S. 410, 424, 425, 53 S. Ct. 207, 77 L. Ed. 397, and *Dalton v. Bowers*, 287 U.S. 404, 53 S. Ct. 205, 77 L. Ed. 389. Also is the multiplicity of transactions required by the several leases creating a business obligation to the corporations as distinguished from the 'single transaction' occurring in the 'lifetime' of the taxpayer 'but once' of *Deputy v. DuPont*, 308 U.S. 488, 495, 60 S. Ct. 363, 84 L. Ed. 416."

The facts are even stronger in the instant case for the finding that Petitioner was in the business of acquiring, owning, expanding, equipping and leasing a bottling plant and other businesses.

Petitioner was in the real estate business aside from these bottling enterprises. (R. 47)[1] He had twice bought premises and equipped them for lumber yards, (R. 90-91; R. 101-102). Throughout 1951-1953 he was leasing land and buildings to Whipple Lumber Co. (R. 102-103; R. 106), and also had a rent house (R. 170; Exhibit 13-M). The Tax Court found that he acquired land in Pasadena, Angleton, Bellaire, and Houston, Texas, and engaged in sales activities with respect to such lands during 1951

[1] Stipulation 30 (R. 47). On January 14, 1954, petitioners filed a joint Declaration of Estimated Tax, Form 1040-ES, photostat of which is hereto attached, marked Exhibit 20-T1, and made a part hereof. On March 11, 1954 they also filed a joint individual income tax return, Form 1040, which is also attached, marked Exhibit 20-T and made a part hereof. In the schedules attached to the return income was shown as received by petitioner as follows:

Salaries from 6 corporations
Interest from 4 parties
One partnership
Rent from three properties

through 1953. (R. 26). Also he had formed an equipment rental corporation to lease equipment to lumber yards and construction companies. (R. 101).

The Tax Court found "Individually, petitioner was in the construction or real estate business". (R. 31).

Petitioner reported $15,570.58 net rentals in 1952 (R. 111; Exhibit 13-M; R. 154) and $12,225.19 in 1953 (R. 47; R. 111; Exhibit 20-T, R. 176) as ordinary income on his returns for those years. Had Mission Orange been successful he would have reported a great deal more rental income because of the ten year lease he had with it.

The Tax Court in its Findings of Fact (R. 28) states:

> "In 1952 petitioner erected a bottling plant on land which he purchased in Lubbock, Texas. The land and building costs a total of $43,601.70. On July 14, 1952, petitioner leased this plant to Mission Orange for a 10-year term, beginning August 1, 1952, with an option to renew. The prescribed rental was $500 per month for the first 3 years and $500 per month plus 1 per cent of gross sales thereafter. In his 1952 and 1953 return, petitioner claimed a deduction for depreciation of the bottling plant in Lubbock. These returns reflect that petitioner received no rent during either year for that building."

The reason, of course, that Petitioner did not collect the rent during these two years was that the debtor corporation could not afford to pay him. Since Petitioner's potential rental income was so substantial and the building cost him ($43,601.70), considerably more than he had invested ($31,800) in the bottling corporation, it

is reasonable to deduce that his advances made to Mission Orange Bottling Co. were to a significant degree to help it make his rental business profitable.

It was conceded early in tax law that activities in renting properties constituted a business. *Higgins v. Commissioner*, 312 U.S. 212, 85 L. Ed. 783.

Therefore, it is clear that Petitioner was in the business of acquiring, owning, expanding, equipping, leasing and renting real estate and equipment out of the conduct of which business the $56,975.10 bad debt resulted.

Whereas the case of *Maloney v. Spencer*, (9 Cir.) 172 F. 2d 638, 49-1 USTC para. 9176, involved the question of whether the taxpayer was in a business which would entitle him to carry back a net operating loss of $95,-081.48, the reasoning of the case would seem to apply even more strongly to a business bad debt loss. *Maloney v. Spencer* was cited as authority for business bad debt treatment in the cases of *Giblin v. Commissioner*, (5 Cir.), 227 F. 2d 692, 56-1 USTC para. 9103, *Commissioner v. Stokes' Estate* (3 Cir.), 200 F. 2d 637; 53-1 USTC para. 9164, *Scott v. Commissioner*, 14 T.C.M. 1028, *Mays v. Commissioner* (6 Cir.), 272 F. 2d 788; 60-1 USTC para. 9122; and *Trent v. Commissioner*, (2 Cir.), 291 F. 2d 669; 61-2 USTC para. 9506.

The majority of the Court of Appeals for the Fifth Circuit erred in failing to make any ruling on the fourth point urged by Petitioners in their Petition for Review and Assignments of Errors (R. 39) which read as follows:

> "The Tax Court of the United States erred in failing to make any finding as to petitioners' contention that

> Petitioner, A. J. Whipple was in the business of acquiring, owning, expanding, equipping and leasing bottling plants and other equipment out of the conduct of which business the $56,975.10 bad debt loss resulted in the calendar year 1953."

Since as pointed out above, the facts of the instant case clearly bring it within the rule of *Maloney v. Spencer* (supra) a recognized authority of long standing, the Tax Court and the Court of Appeals, by failing to sustain Petitioner's contention that he was entitled to treat the $56,975.10 loss as a business bad debt because it resulted in the conduct of his "business" as defined by *Maloney v. Spencer*, erred, which requires the reversal of this case.

Fourth Point (Restated)

The Court of Appeals for the Fifth Circuit and the Tax Court erred in failing to hold that the extensive activities of the taxpayer in organizing, managing, operating, financing, lending, equipping and renting to corporations, partnerships and joint ventures constituted a business to which the $56,975.10 bad debt was proximately related.

The Tax Court and the majority of the Court of Appeals for the Fifth Circuit have applied too restrictive a legal standard in judging Petitioner, A. J. Whipple's activities which resulted in their incorrect determination that Petitioners $56,975.10 loss was a non-business bad debt.

In the far reaching and complicated life of America today, there are innumerable types of businesses and countless ways in which a debt becoming worthless may have a proximate relationship to the business activities, as distin-

guished from the investment activities, of taxpayers. The activities of Petitioner, A. J. Whipple, were both far-flung and complicated. Instead of looking at all these activities and trying to determine whether they were in fact business activities, as distinguished from investment activities, and whether the bad debt in question did indeed proximately relate to them, both the Tax Court and the Court of Appeals for the Fifth Circuit tried to narrowly compartmentalize Petitioner's activities and put an orthodox name tag on them.

The Tax Court and the Court of Appeals held that for Petitioner's loss to be treated as a business bad debt he must show that he was either (1) in the separate business of buying and selling corporations; or (2) in the separate business of lending money; or (3) in the business of actually bottling drinks.

Applying the facts to each of these completely independently and separately, the Courts below held that Petitioner did not fall into any one of these three narrow business categories. Therefore, by the application of such narrow standards Petitioner's $56,975.10 loss was determined not to be a business bad debt. This was clearly erroneous and based upon an erroneous construction of "trade or business" as used in Section 23(k)(4). It was pointed out in detail in the Third Point that both Courts below completely ignored one extensive business activity of Petitioner, that of rentals, on which there was substantial evidence submitted and which was vigorously urged before both Courts.

In addition, abundant evidence was introduced as to myriad of business activities, and it was urged that the com-

bination and cumulative effect of these activities clearly put them in the category of business activities as opposed to investment activities. The Tax Court while mentioning Petitioner's claim made no finding or holding thereon. The Court of Appeals did not even mention such a claim.

Petitioner, A. J. Whipple, introduced extensive evidence, and presented his case, both to the Tax Court and to the Court of Appeals for the Fifth Circuit in his brief, on the theory of five different, inter-related types of business activities, namely: (1) organizing, financing and managing corporations; (2) financing enterprises and lending money (3) the conduct of soft drink enterprises (4) the acquiring, owning, expanding, equipping and leasing bottling plants and other properties (5) a combination of these activities.

The Courts below took up a segregated examination of each of the first three of these grounds in turn, rejected each separately on its own facts without consideration of how the activities of the others might affect it, and then ignored the theories of the other two grounds entirely.

The activities of the Petitioner in *organizing* and *managing* corporations, partnerships and joint ventures extended over a period of time from the commencement of his business career in 1941 to and including the year 1953 in which the loss was sustained. This was done in conjunction with twenty-one different people and covered the following types of businesses: construction of houses, (R. 85) rental corporation, (R. 87) plumbing supply house, (R. 88) a tile distributorship, (R. 88) apartment houses (R. 89) a bottling business (R. 95) a retail lumber yard, (R. 90-91) a shingle distributorship, (R. 93) a retail building materials yard, (R. 97) an equipment rental corporation, (R. 101) club, (R. 104), a tile distributorship, (R. 25)

the subdivision of real estate and sale of lots in various towns, (R. 26) which involved putting in streets, sewers and water lines.

In addition the taxpayer bought and operated a restaurant, (R. 105) promoted oil ventures, (R. 65) organized a soft drinks distributorship, (R. 144), and entered into the vending machine business. (R. 115) He was brought other deals to help promote, raise money for and handle, such as the cinder block business in 1953, and the lumber yard promotion deal with Alex Head after that. (R. 66)

Attention is called to the description of the manner in which Petitioner, A. J. Whipple, promoted the tile distributorship (R. 88-89), to show the manner in which he operated.

In *Sage v. Commissioner*, 15 T.C. 299, the court in sustaining the business bad debt deduction gave a description of the taxpayers activities which might have been those of the Petitioner, A. J. Whipple:

> "* * * The petitioner has outlined many separate activities in which he participated from the time he was graduated from college until about 1946. There is testimony that he considered additional proposals which were brought to him at that time and that he was known as a person to whom such proposals might be brought profitably. Some of his activities may appear trivial and it may be inappropriate to fit some of the uses to which he put his time or money, or both, into the pattern of any business regularly carried on by him. But even if some of these are disregarded enough were left to show that he was regularly carrying on a business. There may be difficulty or differences of opinion in defining that business properly but it existed and was apparent. * * *"

In its findings of fact, the Tax Court below found that Petitioner was not in the business of organizing, promoting, managing or financing corporations and that he was not in the business of lending money. (R. 29). Petitioner submits that these were not in reality findings of fact, but legal conclusions, and therefore, are not in any way binding on this Honorable Court. As pointed out in 5 *Am. Jur. 2d*, page 268:

> "Findings of fact based upon an improper and incorrect jury instruction, *or upon the trial courts erroneous view of the law*, may be reviewed and set aside on appeal. * * * Where the finding of the trial judge was based on what, in the opinion of the appellate court, was a legally erroneous conception of the meaning to be attached to words in dispute, that finding although largely based on testimony given before the trial judge, will be disregarded by the appelate court." (Emphasis supplied)

Also in 5 *Am. Jur. 2d*, page 272:

> "The meaning of terms used in a statute or ordinance is generally a question of law."

The question of statutory construction is one of law to be reviewed and resolved by the courts. *Commissioner v. Bedford*, 325 U.S. 283, 292, 89 L.Ed. 1611, *Commissioner v. LoBue*, 351 U.S. 243, 247 100 L.Ed,. 1142. These standards have been recognized by the Supreme Court on numerous occasions as in *Bingham's Trust v. Commissioner*, 325 U.S. 365, 89 L.Ed. 1670, where the court said:

> "Since our decision in the *Dobson*[1] case we have frequently re-examined, as matters of law, determinations

[1] **Dobson v. Commission**, 320 U.S. 489, 88 L.Ed. 289.

> by the Tax Court of the meaning of the words of a statute as applied to facts found by that court. A question of law is not any the less such because the Tax Court's determination of it is right rather than wrong. Whether or not its decision is 'in accordance with law' is a question which the statutes, Internal Revenue Code Section 1141 (c) (1), 26 USCA 1940 Edition, Section 1141 (c) (1), 6 FCA Title 26, Section 1141 (c) (1) expressly makes subject to appellate review."

In the case of *Washburn v. Commissioner*, (8 Cir., 1931), 51 F. 2d 949, 2 USTC para. 794, in reversing the Board of Tax Appeals the court said:

> "The Board here found certain primary facts. It drew therefrom the ultimate conclusion that petitioner was not regularly engaged in trade or business under Section 204(a). This required a construction of Section 204(a) as applied to the facts. The question here is a mixed one of law and fact. * * * That there may be some degree of finality in a finding of fact by an administrative body may be conceded, but such finding cannot take from courts the power to construe a statute and determine whether it covers such a situation as the facts present."

The Second Circuit in *Commissioner v. Smith*, 203 F. 2d 310, 53-1 USTC para. 9317, in reversing the Tax Court's finding that the taxpayer's loss was a business bad debt under Section 23(k)[2] cited the *Washburn* case and said:

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[2] See also **Mays v. Commissioner**, (6 Cir.) 272 F. 2d 788; 60-1 USTC para. 9122, reversing the Tax Court's finding that the taxpayers loss was not a business bad debt within the meaning of Section 23(k).

> "But insofar as this determination involves the interpretation of the statutory language, it raises an issue of law in which the Tax Court's decision is subject to review here."

As shown under the First Point, at the time of the reenactment of Sections 23(k)(1) and 23(k)(4) into the 1954 Code without substantial change, the law as stated in the *Foss*[3], *Campbell*[4], *Sage*[5], *Stokes' Estate*[6], *Maloney*[7], and *Washburn*[8] cases was that the activities of a taxpayer in regularly and continuously organizing and actively managing corporations constituted the carrying on of a business within the meaning of 23(k) and loans made to one of such corporations which became worthless are business bad debts. To use the criteria laid down by *Foss v. Commissioner*, (1 Cir.) 75 F. 2d 326; 35-1 USTC para. 9091:

> "The line comes between those who take the position of *passive investors*, doing only what is necessary from an investment point of view, and those who associate themselves actively in the enterprises in which they are financially interested and devote a substantial part of their time to that work as a matter of business." (Emphasis supplied)

This therefore was and is the law and should have been the test applied to this taxpayer. As shown in Section B

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[3] 75 F. 2d 326, 35-1 USTC para. 9091.

[4] 11 T.C. 510.

[5] 15 T.C. 299.

[6] 200 F. 2d 637, 53-1 USTC para. 8164.

[7] 172 F. 2d 638, 49-1 USTC para. 9176.

[8] 51 F. 2d 949, 2 USTC para. 794.

of our First Point, the great weight of authority since the enactment of the 1954 Code has continued to recognize the *Foss* rule, but, as explained in our Second Point, through a misinterpretation of certain loosely used phrases, a few of the courts have begun the imposition of the additional requirement that the corporations must be organized for sale. These cases make a radical departure from the existing law, which clearly was not contemplated by Congress and is not based on sound income tax principles.

Had the proper rule of law been applied to the facts, as shown above, Petitioner would certainly qualify as having been in the business of regularly and continuously organizing and actively managing corporations. The Tax Court found that he had organized fifteen corporations. (R. 25, R. 26) He maintained his office at 2436 Bissonnet, and the home office of each of his enterprises was located there. He was the dominant stockholder in the various corporations and maintained a constant control.

During the year 1953, Petitioner was actively managing numerous other enterprises besides his concern with Mission Orange. He was operating a restaurant (R. 111), a lumber yard (R. 111) and an equipment rental corporation (R. 111), building houses (R. 11), renting real estate (R. 111) and managing the other phases of his soft drink enterprise. (R. 112)

As shown by his tax return for 1953 (R. 174), he received a total of $33,450 in salaries from six different corporations, $27,177 from a partnership, $1,747 from interest, besides his rental income of $12,225. In that year his operation of Cousin's Restaurant resulted in a $3,960 loss (R. 178). He also loaned between $25,000 and $30,-

000 to Angleton Building and Holding Corporation during 1953. (R. 121)

The Court of Appeals for the Sixth Circuit in *Mays v. Commissioner*, 272 F. 2d 788, 60-1 USTC para. 9122, found that the taxpayers were in a business separate and distinct from that of the corporations which they had organized and managed and pointed up the distinction as follows:

> "Mere participation in a corporate venture by owning stock as an investment does not place one in the busines which the corporation carries on. An individual taxpayer is not allowed to override the corporate entity and take unto himself the tax benefit of 23(k)(1) unless the debt bears a proximate relationship to the taxpayer's own true business as distinguished from that of the corporation. *Commissioner v. Stokes' Estate*, 200 F. 2d 637 (C.A. 3) 53-1 USTC 9164. But where a person invests and takes part in their management beyond passively giving financial aid, a bad debt loss to one of the businesses is incident to his regular vocation and is not the result of an isolated investment."

What the court was recognizing in the *Mays* case (supra) as in the *Foss* rule, established years earlier,[9] was that, in order to organize, arrange for and keep in touch with the financing of, coordinate the various activities of, and make the general policy decisions for a group of enterprises, as in the Whipple case varying fro retail lumber yard to a restaurant to various phases of soft drinks enterprise in Lubbock and Amarillo, rental properties, promotion of oil deals, subdivision of real estate in Pasadena, Angleton and Bellaire, construction of houses in different locations,

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[9] **Foss v. Commissioner**, (1 Cir.) 75 F. 2d 326, 35-1 USTC para. 9091.

managing an equipment rental corporation and other activities, would necessarily take such extensive time, thought and efforts of the taxpayer, completely separate from the actual business operations of each of the enterprises themselves, as to constitute a separate business, distinct from that of the corporation themselves.

For the conduct of this overall general mangerial business, Petitioner, A. J. Whipple, received substantial ordinary income in the form of salaries paid by the various corporations, totaling $62,850.00 for the two years, 1952 and 1953. Obviously, little of these salaries could have been for his services in the day to day routine of the various businesses because of the number and variety of such enterprises, the problems of their coordination and financing and their dispersed locations. The availability of much time for involvement in other than the financing and managerial affairs of the corporations is negated by the evidence and, therefore, the salaries must have arisen largely by virtue of his extensive activities separate and distinct from the particular business of the corporations themselves.

This is the basis for the distinction betwen the activities of those who have organized and are managing and financing a number of corporations as in *Campbell*[10], *Macy*[11], *Mays*[12], and *Maytag*[13] cases from those of the financing and managing of a single corporation as in *Ferguson v. Commissioner* (4 Cir.) 253 F. 2d 403, cited by the majority of the Court of Appeals below.

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[10] 11 TC 510.

[11] 8 TCM 45.

[12] (6 Cir.) 272 F. 2d 788, 60-1 USTC para. 9122.

[13] (US Court of Claims) 289 F. 2d 647, 61-1 USTC para. 9424.

The Petitioner organized a wide variety of businesses with a wide variety of people. But in addition to organizing and managing these enterprises, he engaged in extensive activities which go far beyond those of the ordinary organizer.

Petitioner consistently over a period of ten years financed the various partnerships, corporations and joint ventures in which he had an interest through loans he made individually or through a partnership (R. 92; R. 98; R. 100; R. 121).

Petitioner's tax return for 1951 shows interest received from five corporations and three partnerships (R. 29). His return for 1952 shows interest income received from seven corporations and partnerships, as well as seven individuals. (R. 156) In 1953, Petitioner made loans of $25,000 to $30,000 to the Angleton Building and Holding Company. (R. 121) and $52,500 to Mission Orange Bottling Co. of Lubbock, Inc. (R. 63; Exhibit 21-T; R. 183 ff). His income tax returns for the years 1951-1953 reflect interest income of $1,680.15, $2,285.35 and $1,747.59 respectively (R. 29).

Again the Court took a narrow view in holding that Petitioner was not in the separate business of lending money, overlooking this important business function of financing enterprises in connection with his activities of organizing and managing. The Tax Court seems to be saying that because Petitioner collected interest from corporations which he controlled and from persons who worked for these corporations, that this interest should be disregarded. Nevertheless, this interest was collected and was reported as ordinary income. The Tax Court erroneously held, in applying an incorrect legal standard, that he was not in the

business of lending money. No authority for such a ruling was given but the case of *Scott v. Commissioner*, 14 TCM 1029, which is clear authority for just the opposite.[14]

The Tax Court in this case below went on further to deny the loss business bad debt treatment because Petitioner received no interest from Mission Orange and there was no affirmative evidence that it was obligated to pay interest. It is submitted that this is taking a very narrow view of the facts and circumstances of this case. The practice with the other enterprises to which Petitioner loaned money during this three year period is a clear indication that it was understood that interest would be paid, and the law implies the payment of interest *(Art. 5070, Vernon's Annotated Statutes of the State of Texas)*, but Mission Orange simply was unable to pay it. This is the history of such loss cases!

In this regard, too, Petitioner's situation was strikingly like that of the taxpayer in the case of *Scott v. Commissioner*, 14 T.C.M. 1029.[15]

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[14] In that case twelve enterprises were mentioned in the stipulation which the taxpayer, Scott, had been instrumental in organizing. He had loaned money to six. To six he had not. He was sole owner, an officer, or a director of all of them and took an active part in their activities. The court held:

"The loans were business as opposed to non-business bad debts. **Henry E. Sage**, 15 T.C. 299; **Vincent C. Campbell**, 11 T.C. 510; **Maloney v. Spencer**, 172 F. 2d 638."

[15] In the **Scott** case the taxpayer made advances to a corporation which he had organized with two others, as a result of which the corporation owed him $11,430 at the end of 1948. He continued to advance money until April 10, 1950, at which time the corporation owed him $35,568.50 after repayments amounting to $4,100. The court stated in its finding of fact that he had no intentions in the beginning of advancing so much money. No interest was ever paid on the loans. In its holding the court stated:

"Interest was due but was never paid, only because the business was never successful enough to pay it."

Whether or not Petitioner technically fell in the narrow category of being in the business of "lending money" the evidence is clear that he was carrying on extensive activities of financing these corporations and enterprises which, when combined with his other activities of organizing and managing these corporations and partnerships, are in the nature of the conduct of a business rather than those of a passive investor.

In addition to Petitioner's activities in organizing, managing and financing corporations, partnerships and joint ventures, he supplied the very plants and offices out of which all of these operated, and through this activity he generated substantial sums of ordinary income.

As Petitioner, A. J. Whipple, had done years before (R. 93), he bought a location for a lumber company, leased it to Whipple Lumber Company and all the other corporations and partnerships, except those engaged in the soft drink business, operated out of it (R. 103). He formed Whipple Equipment Company which rented trucks and equipment necessary for the conduct of these businesses. (R. 101). In the same manner Petitioner, A. J. Whipple, purchased land, building and plant and leased it to Mission Orange Bottling Co. at $500 per month. (R. 44, R. 28) These activities are analogous to those of the taxpayer in *Maloney v. Spencer,* (9 Cir.) 172 F. 2d 623, 49-1 USTC para. 9176.

Not only, as shown in Point Three, are these rental activities sufficient in themselves to constitute a business[16] to which the bad debt loss was proximately related, but, when taken in conjunction with Petitioner's activities in

[16] **Higgins v. Commissioner,** 312 U.S. 212, 85 L.Ed. 783.

organizing, managing and financing corporations, they make it even clearer that his activities were of a business nature rather than merely those of a passive investor.

In examining the issue of whether or not Petitioner was engaged in the business of carrying on a soft drink enterprise, the court again took an overly restrictive point of view and failed to come to grips with the real issue. The phrase "soft drinks enterprise" is used because we submit that the court's use of the term "bottling business" accounts for the court's very narrow examination.

The record shows that this soft drinks enterprise was started by Petitioner, A. J. Whipple, buying a plant to operate personally. In order to do this he had to qualify personally as a proper person to whom a franchise should be issued. He did qualify and continued from 1951 through 1953 to be the holder of this franchise and personally responsible for the fulfillment of its conditions. (R. 57).

In addition to that, as mentioned before, he built the plant and rented it to the corporation he formed to carry on the bottling phase of the operation itself.

Also, he financed and supplied the money for the operation of the soft drinks enterprise, and many of the trade creditors required his personal guarantee of its operating obligations. (R. 124).

He personally engaged in the soft drinks vending business and organized a soft drinks distributorship (R. 114-115) both different functions of the soft drinks enterprise and separate from the actual bottling of the drinks.

He was, therefore, as a holder of the franchise, a supplier of the building, the credit, and the furnisher of the

financing for the bottling plant, an owner of a vending operation, and an organizer of a distributorship engaged in an over-all soft drinks enterprise. The Mission Orange Bottling Co. of Lubbock, Inc. carried on only the *bottling* phase of this over-all enterprise. The over-all management, the equipping and coordination of these various phases of this soft drinks enterprise, and the handling of its many financing needs constituted business activities separate and apart from the bottling operation carried on by the Mission Orange Bottling Co. of Lubbock, Inc.

As clearly brought out by the testimony of C. L. Barnhardt, District Representative of Mission Dry Corporation, Petitioner, A. J. Whipple, was the over-all manager of the soft drinks enterprise (R. 58), was active in its operation throughout the period from 1951-53 (R. 59) and after August, 1953 was actually the manager of the bottling plant itself. (R. 119)

On December 14, 1953, the Mission Orange Bottling Co. owed Petitioner, A. J. Whipple, $79,389.76 and owed trade creditors approximately, $48,000. (R. 28) On the next day Petitioner Whipple loaned the corporation $48,000 and received as a credit on the account that the corporation owed him, all the bottling equipment in the plant at its book value of $67,332.91 and an automobile for $3,081.75, (R. 78) thus leaving a balance due him of $56,975.10, which became worthless. (R. 74).

When on December 15, 1953, he loaned the bottling corporation $48,000 to pay off trade creditors he was acting to protect the credit of his franchise and over-all operation of this soft drinks enterprise, which showed, as in *Lutz v. Commissioner* (5 Cir.) 282 F. 2d 614, 60-2 USTC para. 9687, that the loan was incurred in his trade or business.

The loss which Petitioner sustained by reason of the debt becoming worthless was proximately related to the business in which he was engaged. Petitioner submits that it was directly related to his soft drink enterprise and, likewise, to his business of organizing, managing and financing and renting to corporations, of which the soft drink enterprise was one facet. The debt was like that in *Macy v. Commissioner*, 8 TCM 45 where the court said:

> "We think that the debts herein were business rather than nonbusiness bad debts because the evidence shows that they had a direct connection with the business carried on by the petitioner and the loss was the result of, and incurred in the petitioner's business of promoting various enterprises and corporations which business was carried on by the petitioner during the years involved and had been carried on by him for many years prior thereto."

Similarly, the Tax Court in *Campbell v. Commissioner*, 11 T.C. 510, expressed the situation when it stated:

> "* * * they were business rather than nonbusiness bad debts because the evidence shows that they had a direct connection with the business carried on by these petitioners and the losses were directly a result of, and incurred in, the business of organizing and operating corporations engaged in the retail coal business, which business of organizing and operating such corporations was carried on by the petitioners during the taxable year."

In the case of *Washburn v. Commissioner* (8 Cir.) 51 F. 2d 949, 2 USTC para. 794, the court clearly stated the issue as: "Was petitioner regularly operating a trade or business?" The case involved Sec. 204(a) of the Revenue Act of

1921, a net operating loss statute, but it is equally applicable to the activities of Petitioner. The following language is particularly pertinent:

> "The statute does not provide that to secure the benefits the taxpayer must be engaged in only one business. It is any 'trade or business'. A party may be engaged in many kinds of business and still be entitled to the benefit of the statute."
>
> "* * * Whether petitioner's business, viewing his entire activities, be regarded as a general one involving active participation in the supervision of the various companies in which he was interested, or whether he be regarded as carrying on a number of separate kinds of business, among which was the development of the timber holdings, the loss in question occurred in a business regularly carried on."

It is apparent from the record that Petitioner was regularly and continuously organizing, financing, renting to and actively managing corporations. He was at all times "more than a passive investor". His activities were "extensive, varied, continuous, and regular. Here is the regularity as distinguished from the isolated or occasional transaction. Here is the frequency and continuity of transactions which give them business status."

These activities were of the type which were reasonably calculated to, and in Petitioner, A. J. Whipple's case did, generate substantial amounts of ordinary income from sources separate and distinct from the conduct of the particular businesses of the corporations themselves. Through all these activities, for the most part carried on separate from the particular business of the corporations themselves, Petitioner generated ordinary income in the years 1952-

1953 in the form of salaries, in the form of rents and in the form of interest in the total amount of $94,658.71. Had his soft drinks enterprise been a success, the income from all three of these sources would have undoubtedly been greater, and, as a result of his efforts to make it so, the $56,975.10 bad debt loss in question resulted.

The Tax Court, applying an incorrect legal standard, as affirmed by the majority of the Court of Appeals for the Fifth Circuit, erroneously failed to hold that Petitioner, A. J. Whipple was engaged in the business of organizing, financing, renting to and managing corporations, partnerships and joint ventures as a proximate result of the conduct of which business the bad debt in question resulted. Such failure is error, requiring this case to be reversed and rendered.

CONCLUSION

Petitioner prays that the judgments of the Tax Court and the Court of Appeals for the Fifth Circuit be reversed and rendered by this Honorable Court.

The case should be reversed because the Courts below applied an incorrect legal standard to the activities of Petitioner, A. J. Whipple, in determining that the $56,975.10 bad debt loss he sustained was not incurred in his "trade or business" as used in Section 23(k)(4) IRC 1939.

This case should be rendered and judgment entered allowing Petitioner a business bad debt deduction in the amount of $56,975.10, as prayed for in Petitioner's Petition for Redetermination of the Deficiency because the

record clearly shows that the $56,975.10 bad debt of Mission Orange Bottling Co. of Lubbock, Inc., was incurred in Petitioner's trade or business within the meaning of Section 23 (k) of the Internal Revenue Code of 1939.

Respectfully submitted,

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PROOF OF SERVICE

It is hereby certified that five copies of the above and foregoing Brief of Petitioner were served on Archibald Cox, Solicitor General, Department of Justice, Washington 25, D. C., by depositing the same in the United States Post Office at Houston, Texas, air mail postage prepaid on this ___ day of January, 1963.

_____
Counsel for Petitioners